



# **NAVAL POSTGRADUATE SCHOOL**

**MONTEREY, CALIFORNIA**

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## **MBA PROFESSIONAL REPORT**

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**Evaluation of the Department of the Navy's (DoN's)  
Managers Internal Control (MIC) Manual**

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**By:     LaTresa Steward  
        David A. Kobie  
        Dale A. Haney  
        December 2008**

**Advisors:     Kenneth Euske  
                Lisa Potvin**

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<b>REPORT DOCUMENTATION PAGE</b>			<i>Form Approved OMB No. 0704-0188</i>	
Public reporting burden for this collection of information is estimated to average 1 hour per response, including the time for reviewing instruction, searching existing data sources, gathering and maintaining the data needed, and completing and reviewing the collection of information. Send comments regarding this burden estimate or any other aspect of this collection of information, including suggestions for reducing this burden, to Washington headquarters Services, Directorate for Information Operations and Reports, 1215 Jefferson Davis Highway, Suite 1204, Arlington, VA 22202-4302, and to the Office of Management and Budget, Paperwork Reduction Project (0704-0188) Washington DC 20503.				
<b>1. AGENCY USE ONLY (Leave blank)</b>		<b>2. REPORT DATE</b> December 2008	<b>3. REPORT TYPE AND DATES COVERED</b> MBA Professional Report	
<b>4. TITLE AND SUBTITLE</b> Evaluation of the Department of the Navy's (DoN's) Managers Internal Control (MIC) Manual			<b>5. FUNDING NUMBERS</b>	
<b>6. AUTHOR(S)</b> LaTresa Steward, Dale A. Haney, David A. Kobie			<b>8. PERFORMING ORGANIZATION REPORT NUMBER</b>	
<b>7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES)</b> Naval Postgraduate School Monterey, CA 93943-5000				
<b>9. SPONSORING /MONITORING AGENCY NAME(S) AND ADDRESS(ES)</b> N/A			<b>10. SPONSORING/MONITORING AGENCY REPORT NUMBER</b>	
<b>11. SUPPLEMENTARY NOTES</b> The views expressed in this thesis are those of the authors and do not reflect the official policy or position of the Department of Defense or the U.S. Government.				
<b>12a. DISTRIBUTION / AVAILABILITY STATEMENT</b> Approved for public release; distribution is unlimited			<b>12b. DISTRIBUTION CODE</b>	
<b>13. ABSTRACT (maximum 200 words)</b> <p>The purpose of this MBA project was to conduct a comprehensive review of the current DoN Manager's Internal Control (MIC) Manual to evaluate its effectiveness in helping to align the Navy's current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs. Additionally, this study reviews the (MIC) manual to evaluate its ease of use or identify potential challenges in applying the concepts as outlined in the aforementioned manual. The primary framework used in evaluating the MIC manual was a report published by Government Accountability Office (GAO) titled: Internal Control Management and Evaluation Tool (2001) which is based upon the five standards for internal control in the federal government. Although the MIC manual provides an interpretation of the guidance and requirements set forth by SECNAVINST 5200.35E, the manual falls short in transcending or translating the spirit and intent of SECNAVINST 5200.35E and other statutory and regulatory references. The MIC manual's ease of use is hindered due to the strict focus on providing instructional guidance in adhering directly to the requirements of SECNAVINST 5200.35E alone. Additionally, it is challenging for the reader to grasp the purpose and vision of the program given that the overarching organizational goals and objectives are not clearly stated within the manual. Structuring the MIC manual to reflect GAO's five standards of internal control will increase its effectiveness in aligning an organizations' current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs.</p>				
<b>14. SUBJECT TERMS</b> Managers' Internal Control Manual (MIC Manual), Managers' Internal Control Program (MIC Program), Internal Control (IC), Internal Control Systems, GAO's Internal Control Management and Evaluation Tool, GAO Tool, Internal Control Standards, Internal Control Components, Federal Government, Internal Control Defined, Limiting Factors			<b>15. NUMBER OF PAGES</b> 113	
			<b>16. PRICE CODE</b>	
<b>17. SECURITY CLASSIFICATION OF REPORT</b> Unclassified	<b>18. SECURITY CLASSIFICATION OF THIS PAGE</b> Unclassified	<b>19. SECURITY CLASSIFICATION OF ABSTRACT</b> Unclassified	<b>20. LIMITATION OF ABSTRACT</b> UU	

NSN 7540-01-280-5500

Standard Form 298 (Rev. 2-89)  
Prescribed by ANSI Std. Z39-18

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**EVALUATION OF THE DEPARTMENT OF THE NAVY'S (DON'S)  
MANAGERS INTERNAL CONTROL (MIC) MANUAL**

LaTresa Steward, Captain, United States Marine Corps

David A. Kobie, Captain, United States Marine Corps

Dale A. Haney, Lieutenant, United States Navy

Submitted in partial fulfillment of the requirements for the degree of

**MASTER OF BUSINESS ADMINISTRATION**

from the

**NAVAL POSTGRADUATE SCHOOL**

**December 2008**

Authors:

\_\_\_\_\_  
LaTresa Steward

\_\_\_\_\_  
David A. Kobie

\_\_\_\_\_  
Dale A. Haney

Approved by:

\_\_\_\_\_  
Kenneth Euske, Lead Advisor

\_\_\_\_\_  
Lisa Potvin, Support Advisor

\_\_\_\_\_  
Terry Rea, CAPT, USN, Acting Dean  
Graduate School of Business and Public Policy

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# **EVALUATION OF THE DEPARTMENT OF THE NAVY'S (DON'S) MANAGERS INTERNAL CONTROL (MIC) MANUAL**

## **ABSTRACT**

The purpose of this MBA project was to conduct a comprehensive review of the current DoN Manager's Internal Control (MIC) Manual to evaluate its effectiveness in helping to align the Navy's current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs. Additionally, this study reviews the (MIC) manual to evaluate its ease of use or identify potential challenges in applying the concepts as outlined in the aforementioned manual. The primary framework used in evaluating the MIC manual was a report published by Government Accountability Office (GAO) titled: Internal Control Management and Evaluation Tool (2001) which is based upon the five standards for internal control in the federal government. Although the MIC manual provides an interpretation of the guidance and requirements set forth by SECNAVINST 5200.35E, the manual falls short in transcending or translating the spirit and intent of SECNAVINST 5200.35E and other statutory and regulatory references. The MIC manual's ease of use is hindered due to the strict focus on providing instructional guidance in adhering directly to the requirements of SECNAVINST 5200.35E alone. Additionally, it is challenging for the reader to grasp the purpose and vision of the program given that the overarching organizational goals and objectives are not clearly stated within the manual. Structuring the MIC manual to reflect GAO's five standards of internal control will increase its effectiveness in aligning an organizations' current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs.

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## **ACKNOWLEDGMENTS**

We would like to thank Professor Kenneth Euske and Captain Lisa Potvin. Without their help and guidance, the completion of this professional report would not have been possible.

We would also like to thank our families for their steadfast support and understanding.

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## **I. INTRODUCTION**

### **A. PROJECT PURPOSE**

This study reviews the current DoN Manager's Internal Control Manual to evaluate its effectiveness in helping to align the Navy's current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs.

### **B. PROJECT OBJECTIVES**

- Determine if the MIC manual aligns with the spirit and intent of the SECNAVINST 5200.35E and other pertinent statutory and regulatory references
- Identify ease of use and/or any potential challenges in applying the concepts as outlined in the aforementioned manual.
- Review current DoN Managers' Internal Control (MIC) Manual to evaluate its effectiveness in aligning an organizations' current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs

### **C. BACKGROUND**

As stated in SECNAV Instruction 5200.35E:

DoN Personnel are responsible for the proper stewardship of Federal resources as a basic obligation of their public service. They must ensure government resources are used in compliance with the laws and regulations, consistent with mission, and with minimal potential for waste, fraud, and abuse. Management Controls (MCs) and Internal Controls (ICs) are synonymous terms to describe the tools military and civilian managers use to achieve results and safeguard the integrity of programs. IC's are sound management practice and play an important role in achieving business and mission objectives throughout the DoN. Under the authority of SECNAVINST 5430.7N, Assignment of Responsibilities and Authorities in the Office of the Secretary of the Navy, 9 June 2005, the Secretary of the Navy Instruction (SECNAVINST) 5200.35E, the Department of the Navy (DoN) Managers' Internal Control (MIC) program regarding internal controls across the DoN was issued. (SECNAVINST 5200.35E, 2006, p. 1)

The MIC manual specifies procedures for implementing an internal control program throughout the DoN. The internal control program serves as management's basis for the DoN annual Statement of Assurance. "Internal control should be recognized as an integral part of each system that management uses to regulate and guide its operations rather than as a separate system within an agency" (GAO/AIMD 00-21.3.1, 1999, p. 5). The MIC Manual is applicable to the Offices of the Secretary of the Navy, The Chief of Naval Operations (CNO), the Commandant of the Marine Corps (CMC), and all Navy and Marine Corps activities, installations, commands, ships, and stations.

#### **D. LITERATURE REVIEW**

"Internal control is management control that is built into the entity as apart of the infrastructure to help managers run the entity" (GAO/AIMD 00-21.3.1, 1999, p. 6). By analyzing the DoN MIC Program Manual, the authors of this report seek to determine the effectiveness of implementing this program throughout an organization. Several reports and audits have been conducted (GAO Report 03-147, GAO Report AIMD-99-19, and Comptroller General Report AFMD-81-30) sighting internal control weaknesses within the Department of Defense and DoN. However, the majority of these audits/reports focused on shortcomings within various operational or program levels such as inventory management, transportation, travel cards, credit cards, improper payment disbursing, and financial management rather than the MIC program or manual. A common thread of these audits blame operational and program deficiencies on poor internal management controls. Follow-on guidance and reports by GAO and other organizations have been issued in order to strengthen management controls. A review of these reports did not reveal that a study of the MIC program manual has been conducted to date.

##### **1. Department of the Navy's First-Year Implementation of the Federal Managers' Financial Integrity Act (FMFIA)**

In 1984, GAO conducted a review and analysis of the Navy's implementation of the Federal Managers' Financial Integrity Act of 1982, which required executive agencies to provide reports detailing the adequacy of internal accounting and administrative control systems. GAO found that the Navy was making progress in strengthening internal



controls, but had issues with the delays in achieving a satisfactory Internal Management Control program throughout the Navy. Specifically, these issues pertained to shortcomings resulting from limited timeframes and staff resources in the Office of the Comptroller of the Navy. These limitations contributed to late and limited guidance from the Office of the Comptroller of the Navy to headquarters components and field activities. GAO concluded that DoN Managers at all levels needed to give more support in order to implement the program successfully (GAO/NSIAD-84-94, 1984).

## **2. Standards of Internal Control**

The Financial Manager's Financial Integrity Act (FMFIA) of 1982 tasked GAO with developing and issuing standards for internal control within the federal government. This mandate provided an overall framework for establishing and maintaining internal control or identifying major performance or management challenges within federal agencies (OMB; FMFIA, 1982). In 1999, GAO published a report titled *Standards for Internal Control in the Federal Government*. This report updated the previous "Standards for Internal Control in the Federal Government" instituting the private sector's internal control guidance of Internal Control-Integrated Framework, published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (GAO/AIMD 00-21.3.1, 1999, p. 1). This report defined controls as "A major part of managing an organization... comprising the plans, methods, and procedures used to meet missions, goals, and objectives, and in doing so, support performance-based management" (GAO/AIMD 00-21.3.1, 1999, p. 4). The report lists and defines the Five Standards of Internal Management Controls as Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring (GAO/AIMD 00-21.3.1, 1999).

## **3. Internal Control Management and Evaluation Tool (GAO Tool)**

In 2001, GAO published a report titled *Internal Control Management and Evaluation Tool (herein referred to as the "GAO tool")*. This publication provides "a systematic, organized, and structured approach to assessing the internal control structure"

(GAO-01-1008G, 2001, p. 1). The GAO tool is based on and corresponds to the five standards for internal controls published by GAO in 1999. The use of the GAO tool is not required; however, it is designed to assist federal agencies in implementing as well as maintaining and sustaining effective internal control. The GAO tool was developed using input from multiple documents, but the primary sources included the GAO's *Standards of Internal Control in the Federal government*, as well as information contained within the "Evaluation Tool" section of the *Internal Control-Integrated Framework*, developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Existing legislation also contributed in the development of the GAO tool. The Acts included the Federal Managers' Financial Integrity Act (FMFIA) of 1982, the Chief Financial Officers Act of 1990, the Government Performance, and Results Act (GPRA) of 1993, and the Federal Financial Management Improvement Act (FFMIA) of 1996 (GAO-01-1008G, 2001).

As outlined above, the GAO tool not only directly corresponds to the five standards for internal controls (Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring) that were published by GAO in 1999, but it also contains checklists and methods for assessing independent evaluations and the resolution of audits or other reviews. Each of the above listed standards is an independent section within GAO's tool and is sub-divided into major factors. For example, the Control Environment is sub-divided into major factors such as Integrity and Ethical Values, Commitment to Competence, and Organizational Structure. These major factors are further broken down into points and subsidiary points. Organizational Structure for example, is broken down into five points, the first of which considers whether the organizational structure is appropriate for the size and purpose of its operations. Under these five points are several additional subsidiary points that an organization using the GAO tool should review. Within the GAO tool, any stated standard, major factor, point, or subsidiary point can be used as a guide while assessing internal controls of an organization. Further, the GAO tool is formatted as a checklist and is equipped with a section for adding comments or listing descriptions regarding

internal control strengths and weaknesses. Using the GAO tool also enables an organization or designated representative to assess the applicability of various internal controls within the organization (GAO-01-1008G, 2001).

#### **4. Major Management Challenges**

In 2003, GAO produced another report titled *Major Management Challenges and Program Risks for the DoD*. This report, which focused on performance and accountability, identified systemic and specific problems with management processes related to strategic planning, human capital, support infrastructure, financial and information management, acquisition reform, contracting processes, and logistics reengineering (GAO-03-98, 2003). The report asserts that “significant management problems continue to impact the economy, effectiveness, and efficiency of DOD’s business processes” (GAO-03-98, 2003, p. 1). Although these discrepancies were largely seen as negative, the GAO did note that the DoD had taken positive action in transformation and improvement initiatives. The GAO concluded that the long-standing financial management problems greatly contributed to (and adversely affected) the DoD’s ability to control costs, ensure basic accountability, anticipate future costs, measure performance, maintain funds control, prevent fraud, and address pressing management issues (GAO-03-98, 2003).

#### **5. Effective Internal Controls Is Key to Accountability**

In 2005, GAO published a report titled *Financial Management: Effective Internal Control Is Key to Accountability*. This report was a summation of testimony given before Congress. “This testimony outlines the importance of internal control, summarizes the long-standing Congressional interest in internal control and the related statutory framework, discusses GAO’s experiences and lessons learned from agency assessments since the early 1980s, and provides GAO’s views on the Office of Management and Budget’s (OMB’s) recent revisions to its Circular A-123” (GAO-05-321T, 2005, p. 1). It recognized six areas of importance in order to implement OMB Circular 123 successfully. Specifically:

The need for supplemental guidance and implementation tools; vigilance over the broader range of controls covering program objectives; strong support from managers throughout the agency and at all levels; risk-based assessments and an appropriate balance between the costs and benefits of controls; management testing of controls in operation to assess if they are designed adequately and operating effectively; and management accountability for control breakdowns. (GAO-05-321T, 2005, p. 1)

This testimony asserted that internal controls were at the center of accountability (GAO-05-321T, 2005).

## **6. Report on DOD Compliance with Federal Managers' Financial Integrity Act (FMFIA) of 1982**

In 2007, DoD Inspector General's Officer published Report on DoD Compliance with FMFIA of 1982. The report reviewed and compared feeder components Statements of Assurance, GAO reports, audits, inspections, and investigations to find concurrence or differences with the DoD Annual Statement of Insurance for Internal Controls. The report concluded that the DoD did not "have an adequate basis for giving a qualified opinion on the effectiveness of internal control over financial reporting as long as current weaknesses continue to exist" (DoD IG Report D 2007-093, 2007, p. 10). However, the report stated they "did not perform an in-depth review of the process used by DoD management to assess the effectiveness of internal controls over financial reporting as required by OMB-123" (DoD IG Report D 2007-093, 2007, p. 10).

## **7. Sustaining Internal Controls**

In 2007, K. Bresnahan published the article, Sustaining Internal Control Programs. He concluded that sustaining internal controls required organizations to possess not only sound internal controls but to also possess a sustainment structure for internal controls. A successful sustainment structure would have the following key characteristics: effective internal control program; focused and flexible leaders; flexibility in changing controls to the changing environment; the ability to respond adequately to updates, testing, and remediation; continual planning; an ability to assess and determine the effectiveness of an assessment process; and possess a proactive cultural mindset.

According to the article, OMB's new rules accomplished a clear understanding that management must be proactive in determining effective controls (Bresnahan, 2007, p. 45).

To summarize, the literature review identified several audits and reports, which cited weaknesses in IC's within the DoD and DoN. While the majority of the audits/reports focused on operational and management control weaknesses, none were found to contain a direct assessment of overarching IC systems or programs. Further, a review of these reports did not reveal that an assessment of the MIC program and manual had been completed. The literature review also identified the GAO Tool; a publication that was recognized by the authors of this report as a sound means for evaluating the MIC manual. Finally, the remaining reports (within the literature review) provided additional justification regarding the importance of IC's and the need for assessing the MIC manual.

## **E. ORGANIZATION**

Chapter I provides an overview of the project: its purpose, objectives, and a brief background. Chapter II contains a review and analysis of multiple statutory and regulatory documents and references which provide a historical chronology of internal control processes leading up to the development and revisions to the current Manager's Internal Control (MIC) Program. This historical review includes the Budget and Accounting Act of 1921, the Budget and Accounting Procedures Act of 1950, the Office of Management and Budget (OMB) Circular, A-123, the Federal Managers Financial Integrity Act (FMFIA) of 1982, the Sarbanes-Oxley Act of 2002, SECNAVINST 5200.35E, and other statutory and regulatory reference materials. Chapter III focuses on defining and discussing various perspectives regarding the purpose of internal controls as viewed in both the federal government and private sector. Additionally, Chapter III identifies the components of an effective internal control, outlines internal control limitations, and explains the methods in which organizations can express internal control requirements. Chapter III also contains discussions surrounding the importance of sustaining internal controls and systems. In Chapter IV, the DoN Managers' Internal Control (MIC) Manual is described in detail to provide the reader with an understanding

of its content. In Chapter V, the MIC manual is evaluated to determine the following objectives: First, does the MIC manual align with the spirit and intent of the SECNAV 5200.35E and other pertinent statutory and regulatory references. Second, is the manual easy to comprehend and implement, or does it contain potential challenges in applying the concepts as outlined in the aforementioned MIC program. Finally, Chapter V reviews the current DoN Managers' Internal Control (MIC) Manual to evaluate its effectiveness in aligning an organizations' current mission, organizational philosophy, management strategy, goals, and metrics, sustainment efforts, and improvement programs. Chapter VI contains conclusions and recommendations.

## **II. ORIGIN OF MIC PROGRAM**

### **A. INTRODUCING THE HISTORICAL SIGNIFICANCE**

In an effort to obtain a clear understanding of what brought about the MIC Program, it is relevant to trace the background and origin of internal control processes within the federal government. By analyzing the lineage of documents pertaining to internal controls throughout the federal government, the authors hope to uncover the spirit and intent, which led to the development of the MIC program and the associated manual within the DoN. Additionally, in tracing the background and origin of internal control processes throughout the federal government, the authors of this report hope to reveal evolutionary changes that have occurred, and the impact these changes have had on the current state of the MIC program.

To accomplish this task, a historical review and analysis of multiple statutory and regulatory documents has been conducted. The below listed references have been reviewed and are considered to have historical significance and bearing on the development of the current DoN's Manager's Internal Control (MIC) Program. The criteria used in determining whether a reference was deemed historically significant involved identifying the primary source document to the MIC program (SECNAVINST 5200.35E), and then tracing the references contained in the SECNAVINST backwards to determine the originating source documents. This tracing process identified the Budgeting and Accounting Act of 1921, the source document, which put internal controls in motion within the federal government. The literature reviewed includes the Budget and Accounting Act of 1921, the Budget and Accounting Procedures Act of 1950, the Office of Management and Budget (OMB) Circular, A-123 (and amendments), the Federal Managers Financial Integrity Act (FMFIA) of 1982, the Government Performance and Results Act (GPRA) of 1993, the Sarbanes-Oxley Act of 2002, DoD Directive 5010.38, DoD Directive 5010.40, DoD Instruction 5010.40, and SECNAVINST 5200.35E. Other statutory and regulatory reference materials that indirectly contributed to the influence of the DoN's MIC program are listed in Appendix A.

## **B. THE BUDGET AND ACCOUNTING ACT OF 1921**

The Budget and Accounting Act of 1921 was characterized as “probably the greatest landmark of our administrative history” (Emmerich, Herbert, 1971. p. 40). The 1921 act established measures that enabled Congress to exercise more control and oversight over federal spending. Signed by Congress June 10, 1921, the act established the requirement for the President to submit an annual consolidated budget proposal to Congress, covering all federal revenues and expenditures for the upcoming fiscal year (Public Law 67-13, 42 Stat. 20).

The 1921 act created a central budget office, the Bureau of the Budget; and a Congressional audit agency, the General Accounting Office. The predecessor to the Office of Management and Budget (OMB), the Bureau of the Budget was established to provide the President with the resources necessary to produce the annual consolidated budget. The General Accounting Office (now referred to as the Government Accountability Office (GAO)) was established to provide Congress with oversight and accountability of the federal budget. The GAO was charged to "investigate, at the seat of government or elsewhere, all matters relating to the receipt, disbursement, and application of public funds, and shall make to the President...and to Congress...reports (and) recommendations looking to greater economy or efficiency in public expenditures" (Public Law 67-13, 42, Sec. 312(a), Stat. 25).

## **C. THE BUDGET AND ACCOUNTING PROCEDURES ACT OF 1950**

Rabin (1992) argues that the Budget and Accounting Act of 1950 is “the most significant development in federal accounting” (Rabin, 1992, p. 248). The act introduced budget reform that outlined the accountability responsibilities of the Comptroller General and established the requirement for unified accounting and reporting systems within the U.S. government agencies. The 1950 act required the Comptroller General of the United States to establish and be responsible for prescribing the accounting principles, standards, and related requirements for accounting as guidance for executive agencies. The 1950 act also required the Treasury Department to establish unified accounting and reporting systems capable of maintaining data on the financial operations and position of the



government as a whole (Rabin, 1992, p. 248) and required the head of each executive agency to establish adequate and effective agency accounting and internal control systems that conformed to the Comptroller General's guidance.

#### **D. INTERNAL CONTROL SYSTEMS; OMB CIRCULAR, A-123, OF 1981**

Office of Management and Budget (OMB), a part of the Executive office of the President, releases documents called circulars that are prepared by various federal agencies concerning issues within their specific departments. One such circular, OMB Circular A-123 was issued in October of 1981. Then titled "Internal Control Systems," OMB Circular A-123 implemented various internal control standards, as well as a system which outlined agency requirements and responsibilities as it pertained to possible fraud, waste, and abuse. OMB Circular A-123 was issued to further develop federal standards for establishing internal controls, identifying internal control weaknesses, and to address compliance issues surrounding the implementation and execution of internal controls. Additionally, according to a Government Accounting Office (GAO) Financial Management Report, OMB first issued Circular A-123 in anticipation of FMFIA becoming Law, (GAO, 2005, p.3).

Circular A-123 contains an array of definitions, which seek to refine and provide a shared understanding of terms such as Internal Control, Internal Control Documentation, Internal Control Guidelines, Internal Control Review, Standards, System, technique, and material weakness. Circular A-123 mandates agencies to maintain an effective system of accounting and administrative control while also charging all levels of management to involve themselves in ensuring adequate controls exist or are implemented. Circular A-123 policy also requires all internal control systems be evaluated on a regular basis and states that new programs *shall* incorporate effective systems of internal control (OMB Circular A-123, 1983, p. 2). Finally, Circular A-123 requires internal control *activities* and *evaluation results* be reported out on an as required basis.

**E. FEDERAL MANAGERS' FINANCIAL INTEGRITY ACT (FMFIA) OF 1982 (P.L. 97-255 - (H.R. 1526))**

In 1982, the Senate and House of Representatives amended the Accounting and Auditing Act of 1950 and Budget and Accounting Act of 1921. The new Act was called the Federal Managers' Financial Integrity Act (FMFIA) of 1982 (OMB; FMFIA, 1982, p. 1). Signed into law September 8, 1982, FMFIA amended the Accounting and Auditing Act of 1950 by adding language which required ongoing evaluations and reports of each executive agency. Specifically, FMFIA required executive agencies to provide reports detailing the adequacy of internal accounting and administrative control systems. Additionally, executive agencies were required to follow standards (as prescribed by the Comptroller General) and provide reasonable assurance that obligations complied with appropriate law and that funds, property, and other assets were safeguarded against fraud, waste, misappropriation, and abuse. The executive agencies were also required to provide reasonable assurance that revenues and expenditures of executive agencies were properly recorded and accounted for in order to facilitate reliable financial reports and maintain accountability (OMB; FMFIA, 1982, p. 1).

FMFIA directed the Director of OMB, in consultation with the Comptroller General to establish guidelines for the evaluation of each agency and their systems of internal accounting and administrative control. This mandate was established to assess whether or not each internal control system was in compliance with the requirements; and was to be complete by December 31, 1982. FMFIA also directed the head of each executive agency to prepare a statement evaluating the compliance of that agency's system of internal accounting and administrative controls. This statement was to be submitted by December 31, 1983, and by December 31 of each succeeding year, (OMB; FMFIA, 1982).

The FMFIA tasked GAO with developing and issuing standards for internal control within the federal government. This mandate provided an overall framework for establishing and maintaining internal control or identifying major performance or management challenges within federal agencies (OMB; FMFIA, 1982).

## **F. GOVERNMENT PERFORMANCE AND RESULTS ACT (GPRA) OF 1993**

The One Hundred Third Congress of the United States of America passed the Government Performance and Results Act (GPRA) into law on January 5, 1993. The law required federal agencies to clarify their missions, set strategic and annual performance goals, and measure their performance in these areas. This Act required that the results be reported OMB. The law was designed to improve the confidence of the American people that the Federal Government was effectively and efficiently managing programs and spending. The Act also identified internal control as an integral part of establishing a framework to measure and achieve set goals that correspond with a strategic vision and mission objective (GPRA, 1993).

## **G. MANAGEMENT ACCOUNTABILITY AND CONTROL; REVISED CIRCULAR, A-123 OF 1995**

Due, in part, to an array of reporting procedures and requirements concerning the monitoring and documentation of internal control processes, OMB made a substantial revision to OMB Circular A-123. Rather than have several different (and independent) internal control policies, assessments, and requirements conducted by auditors and managers throughout various federal agencies, the revised OMB Circular of 1995 provided a framework wherein internal control assessments could be integrated under one organization and into a single document. Additionally, the reporting and assessment requirements of OMB's revised Circular (A-123 of 1995) were relaxed and gave federal agencies more leeway in determining the method for producing the annual assurance statement to Congress (GAO 05-321T, 2005, p. 7-8).

## **H. FEDERAL FINANCIAL MANAGEMENT IMPROVEMENT ACT (FFMIA) OF 1996 (PUBLIC LAW 104-208)**

The FFMIA of 1996 was signed into law in order to improve Federal financial management through improvements within the Federal financial management systems. The FFMIA sought improvements to Federal financial management systems by requiring more accurate, reliable, and timely financial management information to the government's managers. In complying with the FMIA Act, it was argued that the

reliability in the financial management information would increase and in turn, better assist program managers and the Executive and Legislative branches of government in support of public interests (Public Law 104-208, 1996).

## **I. SARBANES-OXLEY ACT OF 2002**

Also known as the Public Company Accounting Reform and Investor Protection Act of 2002, the Sarbanes-Oxley Act (SOX) enacted amendments to the Securities Act of 1934 that changed the regulation of corporate governance and standards for financial accounting practices in the United States (Addison-Hewitt Associates, 2004). Enacted on July 30, 2002 as Public Law 107-204 statute 745, SOX is a piece of legislation focused on improving the quality, reliability and transparency in financial reporting and independent audits and accounting services for all companies regulated by the Securities Exchange Commission (SEC) (Addison-Hewitt Associates, 2004). Arranged into eleven titles, the Sarbanes-Oxley provisions outlines various non-negotiable deadlines for compliance, periodic statutory financial reporting requirements, and integrated auditing and accounting standards (Epstien, Nach & Bragg, 2008).

The principal regulatory focus of SOX is on auditors and corporate management (Epstien, Nach & Bragg, 2008, p. 12). The SOX act not only increases management's responsibility for assessing the effectiveness of internal control over financial reporting (Epstien, Nach & Bragg, 2008, p. 12), but also imposes criminal sanctions on individuals, registered accounting and auditing firms, and publically held companies which fail to comply with the strict accounting oversight and internal control mandates (Welytok, 2008). The SOX act established the Public Company Accounting Oversight Board (PCAOB) to assume the responsibility of monitoring public companies, provide independent oversight of their accounting practices, issue standards for public company audits and regulate the practices of auditors and registered audit firms" (Whittington & Pany, 2008, p. 52).

**J. MANAGEMENT RESPONSIBILITY FOR INTERNAL CONTROL;  
REVISED CIRCULAR, A-123 OF 2004**

In December of 2004, OMB published the most recent revision of Circular A-123. Prompted by the Sarbanes-Oxley Act of 2002, the Department of Homeland Security Financial Accountability Act of 2004, and recommendations from the Chief Financial Officers' Counsel (CFOC) and President's Committee on Integrity and Efficiency (PCIE) joint committee, OMB conducted another review of Circular A-123 in an effort to "strengthen guidance for assessing the effectiveness of internal control," (United States Congress, House Hearing, 2005). Possibly the most substantial amendment to this circular involved the "requirement for agency management to follow a more comprehensive and coordinated approach when assessing the effectiveness of internal control over financial reporting" (United States Congress, House Hearing, 2005). According to testimony before the House of Representatives, Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, GAO,

The changes are intended to strengthen the requirements of conducting management's assessment of internal control over financial reporting... The Circular correctly recognizes that instead of considering internal control as an isolated management tool, agencies should integrate their efforts to meet the requirements of FMFIA with other efforts to improve effectiveness and accountability. (GAO Report 05-321T, 2005, p. 8)

Circular A-123 of 2004 stressed the importance of internal control assessment and documentation by management, updated current terminology being used in the federal government and corporate America, and listed recent financial management internal control documentation that should be followed and considered when reviewing the effectiveness of internal controls.

**K. DOD DIRECTIVE 5010.38; INTERNAL MANAGEMENT CONTROL  
PROGRAM OF 1984**

On July 16, 1984, the Department of Defense issued Directive 5010.38, the Internal Management Control Program. Directive 5010.38 (which cancelled DoD Directive 7040.6; Internal Control Systems, March 24, 1982) established the Internal

Management Controls (IMC) program for the DoD, incorporated guidance under OMB Circular No. 123 and GAO standards for Internal Controls, provided policy, prescribed procedures, and assigned responsibility, (DoD 5010.38, 1984). The current directive (last updated on August 26, 1996) is applicable to all DoD organizations including the Office of the Secretary of Defense (OSD), DoD field activities, the Military Departments, the Organization of the Joint Chiefs of Staff, the Unified and Specified Commands, the Inspector General, DoD, and Defense Agencies. They are collectively referred to as DoD components (DoD 5010.38, 1996).

Concerning policy, DoD directive 5010.38 mandated that each DoD component develop and implement an in-depth system for internal managerial controls that provided reasonable assurance in multiple areas. Specifically, this policy requires the training of IMC managers (focusing on their obligations and responsibilities), the safeguarding of assets from waste, loss, and unauthorized use, compliance with applicable laws regarding all obligations, the proper recording of revenues and expenditures, efficient and effective management of resources, and that attention be placed on preventing mismanagement and correcting specific weaknesses (DoDD 5010.38, 1984). Another policy this directive set forth was to involve all levels of management while also designating a senior management official as having overall responsibility for the design, direction, and implementation of the IMC program. Lastly, this policy mandates the submission of a “statement of assurance” to the Secretary of Defense regarding the adequacy of the IMC system with respect to meeting program standards, goals, and objectives, (DoD 5010.38, 1984).

Concerning procedures, Directive 5010.38 requires each DoD component to develop an IMC program that includes elements such as “organizing the IMC process, segmenting the components into assessable units, conducting vulnerability assessments on those units, developing plans for subsequent action, conducting IMC reviews or appropriate management actions, scheduling and taking corrective action, providing for quality control, and preparing reports” (DoD 5010.38, 1984).

**L. DOD DIRECTIVE 5010.40; MANAGEMENT IMPROVEMENT PROGRAM, 1952**

The DoD issued Directive 5010.40, Management Improvement Program: Work Measurement System and Standards of Performance, on August 21, 1952. According to the directive, its purpose was to recognize the Military Departments' efforts in developing and establishing Work Measurement Systems and to assure continued attention in the essential elements of Management Improvement Programs (DoD 5010.40, 1952, p. 1). The directive encouraged and provided for the maximum exchange of information on metrics and metric systems; although it did not require standardization across DoD. The Work Measurement and Metric Systems were primarily a quantitative measure of work performed. The directive outlined a metric system that was based upon standard output and statistical formulas when considering the mean, variance, and standard deviations used in comparing actual output (DoD 5010.40, 1952).

**M. DOD INSTRUCTION 5010.40; MANAGEMENT CONTROL PROGRAM PROCEDURES**

Standard Subject Identification Code (SSIC) 5010.40 began as a Directive in 1952. Specific documentation of migration of the directive into an instruction was not found. However, SSIC 5010.40 reemerged as a DoD Instruction (5010.40D, Management Control (MC) Program Procedures) on August 28, 1996. This instruction established procedures for implementing and executing the Managers' Internal Control (MIC) Program. The SSIC 5010.40 began as a performance measurement system and evolved into a robust IMC program. The management control program and procedures mandated the following requirements for all DoD Components: to evaluate and identify the need for Internal Controls; monitor their effectiveness through a process they determine; report the adequacy of the system's internal controls; and correct management control weaknesses (DoD 5010.40, 1996).

The Office of the Under Secretary of Defense (Comptroller) is responsible for implementing and managing the Secretary of Defense's program over internal management controls. This instruction cites over twenty different references with the

major purpose of implementing "Federal Managers' Financial Integrity Act of 1982" and OMB No. 123. As discussed in the previous paragraph, the DoD Instruction 5010.40, MC Program Procedures, January 4, 2006 canceled the 1996 Instruction. DoD Instruction 5010.40 implements both DoD Directive 5010.38 and 31 U.S.C. 3512. The DoDI 5010.40 also establishes the DoD Senior Assessment Team and recognizes the changes to OMB Circular, No. 123 of 2005. DoD Instruction 5010.40 also reemphasizes the Federal Manager's Financial Integrity Act (FMFIA) as implemented through the DoD Managers' Internal Control Program (MICP) that requires all DoD managers to review, assess, and report on the effectiveness of internal management controls within the Department of Defense. Additionally, DoD Instruction 5010.40 requires the head of each DoD Component to assign IC responsibility to civilian and military leaders/managers throughout the DoD and provide trained personnel for planning, directing, and implementing the MIC program (DoD 5010.40, 2006).

#### **N. SECRETARY OF THE NAVY INSTRUCTION (SECNAVINST) 5200.35**

SECNAVINST 5200.35, (the Managers' Internal Control (MIC) program regarding internal controls across the DoN) was issued prior to 1987. The actual date of the first publication of SECNAVINST 5200.35 could not be confirmed. However, SECNAVINST 5200.35 was found as a reference contained within SECNAVINST 5430.92A, August 20, 1987. The most recent rendition of SECNAVINST 5200.35E was issued on November 8, 2006 and is used as the current document.

This instruction specifies guidance for implementing an internal control program throughout the DoN. The internal control program serves as management's basis for the DoN annual Statement of Assurance. The SECNAV Instruction 5200.35E outlines the responsibilities of DoN personnel with regard to the proper stewardship of Federal resources as a basic obligation of their public service. SECNAV Instruction 5200.35E also seeks to ensure that government resources are used in compliance with applicable laws and regulations while minimizing the potential for waste, fraud, and abuse. This instruction is the primary reference used in developing the DoN Managers' Internal Control Manual, SECNAV M-5200.35. The manual is applicable to the Offices of the



Secretary of the Navy, The Chief of Naval Operations (CNO), the Commandant of the Marine Corps (CMC), and all Navy and Marine Corps activities, installations, commands, ships, and stations, (SECNAV M-5200.35, 2008).

#### **O. ESTABLISHED HISTORICAL SIGNIFICANCE**

The previous discussion identifies a progression of internal management control processes and philosophies. This progression of strengthening internal management controls through various processes and perspectives is believed by the authors to embody the spirit and intent behind the development of these documents and references.

In tracing the historical background and origin of internal control processes throughout the federal government, the authors have identified several evolutionary changes. The Budget and Accounting Act of 1921 documented a concern for Internal Management Control processes within the federal government. A review of the core statutory and regulatory documents suggest that there was a shift from merely creating, establishing, and mandating internal management controls to the emergence of performance measurement systems a part of evaluating internal controls. Review of reference materials indicate that within the past two decades, the development of overarching programs to address internal management controls has taken precedence. This development of internal management *programs* directly contributed to the creation, development, and continued improvements of the IMC Program and MIC manual. Finally, one could argue that the buildup of federal directives, instructions, policies, procedures, and programs has resulted in more complex and cumbersome reporting requirements.

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### **III. INTERNAL CONTROL**

#### **A. DISCUSSION**

As previously discussed in Chapter II, internal controls have evolved over time within the federal government. Before explaining the changes that have occurred within the federal government (and in corporate America), it is necessary to first discuss the meaning and noteworthiness of internal controls. This chapter focuses on defining and discussing various perspectives regarding the purpose of internal controls. The authors of this report also seek to explore the effectiveness and fit of internal controls as it is currently defined and interpreted within the federal government. In addition to the aforementioned topics, discussions surrounding the GAO standards and components of internal control, the various methods in which an organization can express internal control requirements, and identification of some of the limiting factors of internal controls are addressed. Finally, a section regarding internal control sustainment is presented as a necessary and important function of managing internal controls. Ultimately, these discussions aid in the assessment of the MIC Manual's effectiveness in aligning an organization's mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts and improvement programs.

#### **B. INTERNAL CONTROLS DEFINED**

What is internal control and what are the objectives in having these controls? Depending upon the desired outcome or objectives being sought, organizations have historically defined internal control differently. According to Whittington and Pany, both professors and authors within the auditing field, differing perspectives "have long existed about the meaning and objectives of internal control. Until the early 1990s, many people interpreted the term internal control as the steps taken by a business to prevent fraud – both misappropriation of assets and fraudulent financial reporting," (Whittington & Pany, 2007, p. 246). One of the first publications containing a formal definition of the term internal control can be found in a 1949 American Institute of Accountants (AIA) Bulletin

which stated: “Internal control comprises the plan of organizing and all of the co-ordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies” (AIA, 1949, p. 6). Other definitions appear to be focused more on the financial portion of the business, protecting assets, and planning for the future. As an example, “Internal control refers to the design and utilization of all of the means whereby, from a financial standpoint, management is enabled most effectively to safeguard the company’s assets, administer the current operations and plan for the future” (Cadmus & Child, 1953, p. 4). Additionally, Cadmus and Child refer to internal control measures as applications that management should also use to implement their plans and management philosophy regarding the operation and structure of an organization (Cadmus & Child, 1953, p. 4).

Consistent with Cadmus and Child’s view, Whittington and Pany point out that “Others, while acknowledging the importance of internal control for fraud prevention, believe that internal control has an equal role in assuring control over manufacturing and other processes (Whittington & Pany, 2007, p. 246). The acknowledgment that internal controls encompassed much more than merely deterring fraud prompted a set of professional organizations in corporate America to form a committee to consolidate internal control concepts. This committee, the Committee of Sponsoring Organizations (COSO) would later produce the following definition of internal control:

A process, effected by the entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: Reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. (Whittington & Pany, 2007, p. 246)

In trying to determine how the federal government currently defines and views internal controls, we refer to Chapter II where we discussed that internal controls became a primary focus of the passage of the FMFIA in 1982. As previously stated, the FMFIA Act not only mandated federal organizations assess whether or not each internal control system was in compliance with requirements, but it also required the General Accounting

Office (GAO) to issue standards for internal control in government. These standards for internal control in government can be found in a report titled “Standards for Internal Control in the Federal Government,” (GAO/AIMD-00-21.3.1, 1999). In this report, GAO’s definition of internal control essentially mirrors COSO’s definition, although GAO describes internal controls as “A major part of managing an organization. It comprises the plans, methods, and procedures used to meet missions, goals, and objectives, and in doing so, support performance-based management. Internal control also serves as the first line of defense in safeguarding assets” (GAO/AIMD-00-21.3.1, 1999). The definition also makes reference to obtaining desired results through judicious stewardship of public funds and scarce resources. As the importance and focus on internal controls grew within the private sector and federal government, internal control requirements became increasingly well-defined and more stringent (GAO/AIMD-00-21.3.1, 1999).

### **C. STANDARDS / COMPONENTS OF INTERNAL CONTROL**

For over 50 years, discussions surrounding the components of internal control have been the topic of discussion in various texts. In particular, in 1953, authors Cadmus and Child stated that internal controls included “organization structure, procedures, accounting and other records, reports, standards of performance, and internal auditing” (Cadmus & Child, 1953, p. 5). In reviewing Cadmus and Child’s description of internal controls, one could draw the conclusion that the focus of internal controls was primarily based on desired outcomes as well as efforts to prevent fraud and safeguard assets. This example of internal control components yields some interesting and distinct differences when comparing the components as they are viewed today. Although similarities do exist, the following discussions on contemporary internal control standards and components display the evolution of internal controls throughout history.

As part of the research in this section on internal control, two sources were selected for discussion. The sources are GAO Report (GAO/AIMD-00-21.3.1, 1999) titled “Standards for Internal Control in the Federal Government,” and a book authored by Whittington and Pany titled “The Principles of Auditing and Other Assurance

Services” (2007). The GAO report was generated to address internal controls within the federal government while the Whittington and Pany model discusses components of internal controls that are generally applied within Corporate America. Both the government (GAO’s Standards) and civilian sector (Whittington and Pany’s Components) models are fundamentally the same although the authors noted two subtle variations. First, there is a difference in the terminology used in describing the standards (or components) which a sound internal control should possess. Second, there is a difference between the GAO’s Information and Communication standard as compared to Whittington and Pany’s Accounting Information System subset of the five components of internal control. So as not to limit the scope of assessing internal control within the MIC manual and give the authors a better understanding of internal control standards/components, both the government (GAO’s Standards) and civilian sector (Whittington and Pany’s Components) models were considered and discussed below.

The GAO report (GAO/AIMD-00-21.3.1, 1999) developed five standards for internal control which apply to the federal government. These standards were developed by GAO because of a requirement by the FMFIA which tasked GAO to “issue standards for internal control in government” (GAO/AIMD-00-21.3.1, 1999, p. 1). These standards also take into consideration the GPRA of 1993, which has already been discussed as requiring clarity on mission, strategy, and goals. These five standards are the Control Environment, Risk Assessment, Control Activities, Information and Communications, and Monitoring. These standards define the minimum level of quality acceptable for internal control in government and provide the basis against which internal control is to be evaluated” (GAO/AIMD-00-21.3.1, 1999, p. 7).

The *Control Environment* seeks to foster a positive environment within the organization in order to maintain and strengthen internal controls (GAO/AIMD-00-21.3.1, 1999, p. 8). The control environment is described as the cornerstone by which all other standards are built upon and can be affected by several factors. First, the organization should possess an atmosphere that exhibits strong ethical values. Another factor involves the necessity of all parties being competent in their duties. Management’s operating style, philosophy, and the organization’s ability to provide adequate training

are also other important factors which fall within the control environment (GAO/AIMD-00-21.3.1, 1999, p. 8). A poor management philosophy towards implementing, maintaining or monitoring a control measure can have a substantial negative impact on internal control overall. Having a sound organizational structure is yet another factor that can affect the control environment. A weak organizational structure lacks a sound framework and does not adequately delineate areas of authority or responsibility; something which can impede successful accomplishment of any organizational objective. Finally, the ability to establish and maintain sound relationships with oversight agencies can also impact the control environment (GAO/AIMD-00-21.3.1, 1999, p. 9).

*Risk Assessment*, the second GAO standard for internal control includes assessing both internal and external threats. According to the GAO report, risk assessment “is the identification and analysis of relevant risks associated with achieving the objectives, such as those defined in strategic and annual performance plans... and forming a basis for determining how risks should be managed” (GAO/AIMD-00-21.3.1, 1999, p. 10). Other considerations outlined in the GAO report include the methods used in identifying risk (forecasting, planning, results from audit findings, and quantitative and qualitative ranking mechanisms) and the likelihood of the risk occurring. Finally, mechanisms used in assessing risk should be flexible and applicable to a wide range of frequent changes throughout various government agencies (GAO/AIMD-00-21.3.1, 1999, p. 11).

The third GAO standard for internal control is *Control Activities*. Control activities are established to ensure that the directives from management are executed in an effective and efficient manner. Control activities “are the policies, procedures, techniques, and mechanisms that enforce management’s directives...control activities occur at all levels...and include a wide range of diverse activities such as approvals, authorizations, reconciliations, performance reviews, maintenance of security, and records which provide evidence of execution, (GAO/AIMD-00-21.3.1, 1999, p. 11). The GAO identifies over 10 different categories of various control activities that can be regularly found within all agencies. Some of these categories include the need for having separation or division of duties so as to minimize error or fraud, physical controls over vulnerable assets, high-level reviews of performance, effective management of the

workforce, recording transactions and events in an accurate and timely fashion, restricting access and having accountability over various resources and records, and maintaining proper documentation of internal control transactions. In addition, the GAO dedicates an entire section to categories specifically related to control activities for information systems such as networks and mainframes.

*Information and Communications*; the forth standard for internal control (as outlined by the GAO) stresses the importance of recording and communicating the flow of information in a timely fashion among those within the organization who have the need to know; thereby giving them the ability to execute their internal control and other duties. This standard of internal control places emphasis on the flow of information and communication of not only financial data but operational data as well. This standard also highlights the benefits of developing effective internal communication within an organization as well as maintaining effective communication among external stakeholders.

The last of the five standards of internal control under the GAO model is *Monitoring*. Monitoring is a vital part of the control process and “should assess the quality of performance over time and ensure that the findings of audits and other reviews are promptly resolved... It is performed continually and is ingrained in the agencies operations. It includes regular management and supervisory activities,” (GAO/AIMD-00-21.3.1, 1999, p. 20). The standard of monitoring can occur through self-assessments, external audits, or through direct testing of a control, and it is essential that any noted deficiencies are reported to the individual responsible for the activity as well as reporting to management that is one level higher. Lastly, the monitoring function should include established policies and procedures for the prompt resolution of any negative findings (GAO/AIMD-00-21.3.1, 1999).

Whittington and Pany (2007) identifies the components of internal control as follows: “Internal control of an organization may be viewed as including five components: The control environment, the risk assessment process, the accounting information system, control activities, and the monitoring of controls” (p. 248). The



accounting information system and monitoring components within the Whittington and Pany model differ from that of the GAO standards. These differences are described in the following paragraphs.

The *control environment* seeks to incorporate not only the organizational structure, but also control measures involving ethical values, the assignment of authority and responsibility, and all human resource policies and practices within an organization. The control environment also includes such factors as the operating style of management as well as the integrity and commitment to competence of the individuals within the organization.

*Risk assessment*, something that is not directly specified in the 1953 list of components of internal control, involves an array of considerations that an organization should seek to control. Rapid growth, changes in personnel, the use of a new information system, regulatory or technology changes, and the introduction of new processes all require attention and adequate control measures. Note that the risk assessment component of internal control is relevant not only to the financial objectives of an organization, but also includes the financial, operational, and compliance objectives of an organization as is the case in the GAO model.

The *Accounting information system* component of internal control is very similar to the “accounting and other records” component listed by Cadmus and Child, yet it is distinctly different from the GAO model. This component is primarily focused on controlling financial operations involving the identification, recording and timeliness of valid transactions, proper measurement of value and reporting the correct time periods of transactions, and ensuring control measures exist in order to accurately represent these transactions on a financial statement. The GAO model focuses not only on financial data but emphasizes the analysis of operational data as well.

The *control activity* as a component of internal control refers to areas such as the processing of information, performance reviews, the types of physical controls put in place to safeguard information, and the separation of power among those in the

organization. Unlike Cadmus and Child who list standards of performance as a component of internal control in itself, the Whittington and Pany model identifies standards of performance as a sub-category of control activities.

*Monitoring* of ongoing organizational activities is the last component of internal control. The monitoring of controls entails focusing on both common activities as well as infrequent activities such as internal audits. In addition to monitoring control activities, the monitoring component of internal control also emphasizes monitoring the overarching system or program that has been established to monitor internal controls. In other words, an organization must monitor the internal control program's effectiveness in addition to those activities contained within the program. (Whittington & Pany, 2007, pp. 248-256)

To summarize, both the GAO and Whittington and Pany's models of the five standards/components of internal controls largely mirror one another in overall content. However, there were two distinct differences among both models. The GAO model is unique in assessing the Information and Communications standard. Unlike the Whittington and Pany model, this GAO standard does not limit the focus of information and communication flow to financial data but rather considers and includes the information flow of operational data as well. Conversely, it is also important to note that the Whittington and Pany model's monitoring component included the monitoring of the overarching systems or programs of internal controls whereas the GAO model does not.

#### **D.     LIMITING FACTORS OF INTERNAL CONTROL**

There are several factors, which can limit any internal control. Each has the capability to act as a barrier in effectively controlling a particular function of an organization. Possessing awareness of these limiting factors can therefore aid those who seek to maximize the effectiveness of an operation.

Some of the limiting factors of internal control include excessive cost, internal controls that are too complicated to be understood by those who are supposed to abide by the control measures, and users who are too fatigued or exercise poor judgment (Whittington & Pany, 2007, p. 256). Although an internal control may be feasible in

theory, efforts to apply the control may be unsuccessful because of its complexity. The control measure may be too cumbersome and complex; resulting in confusion and misunderstanding.

Recognizing that control measures provide reasonable assurance rather than absolute assurance, the potential for management to override control measures, and the likelihood of stakeholders reducing compliance to an established control measure over time are additional limiting factors (Whittington & Pany, 2007, p. 256). Concerning cost, even a sound internal control may be found to be cost-ineffective and therefore discarded. According to Merchant and Van der Stede “because of control costs, perfect control is rarely the optimal outcome; what is optimal is control that is good enough at a reasonable cost” (Merchant & Van der Stede, 2007, p. 11).

Based on the literature, these limiting factors appear applicable to both the federal government and corporate America. Although the focus on implementing internal controls shifted from one limiting factor to another over time (for example, from a focus on reducing common errors to a focus on preventing fraud due to collusion), a shared theme in maintaining awareness of limiting factors of internal control has continued to exist over time. One limiting factor regarding internal control, which the authors of this report believe, has particular merit and discussion involves having too many internal controls. Arguably, having too many internal controls lays the groundwork for micro-management and can potentially detract from other more important and existing internal controls. In researching and reviewing the literature, the authors found little documentation or discussions surrounding excessive internal controls as a limiting factor. Rather, the discussions focused on the relevancy of internal controls. Specifically, the authors of Internal Control Against Fraud and Waste presented the point that “even though a certain control measure is possible, it may not be necessary or desirable... Does it control something that is worth while to control?” (Cadmus & Child, 1953, p. 304). As previously stated, the authors of this report are of the opinion that too many internal controls, which are either duplicative or irrelevant, can inhibit other existing and essential controls. More importantly, overly complex or excessive control negatively impacts effectiveness and can reach a level more critical than that of other limiting factors

previously discussed. The relevance in discussing this issue becomes apparent in the following chapters where we evaluate the MIC program and the level of control measures contained within the program and manual.

#### **E. COMMON METHODS IN PRESENTING INTERNAL CONTROLS TO STAKEHOLDERS**

Internal controls are most effective when they are flexible to a changing environment and can be clearly understood by all parties involved. Internal controls and processes should therefore be well-defined and clearly presented by management so those charged with physically carrying out the function or process clearly understand. Several different methods can be used to increase the likelihood of expressing internal controls to stakeholders in an understandable manner. The training of personnel (whether it be formal training or on the job training) is an essential portion of presenting an internal control function. The methods in which a control measure can be presented include reading material, the use of flowcharts, and other communication mediums (Whittington & Pany, 2007, p. 263). Using various communication methods to not only explain the control measure but to also present how the control measure impacts the entire organization often results in an even stronger understanding of internal controls. Additionally, analyzing a process, design, or function from its initial stage through completion yields a powerful understanding of a system and the associated internal controls that have been set in place, (Whittington & Pany, 2007, p. 263).

Whittington and Pany place emphasis on flowcharts as being the superior method in expressing internal controls. Not only do they suggest that a flowchart “provides a clearer, more specific portrayal of a client’s system” (Whittington & Pany, 2007, p. 263), but also make the assertion that “there is less opportunity for misunderstanding, blank spots, or ambiguous statements when one uses lines and symbols (flowchart) rather than words to describe internal control” (Whittington & Pany, 2007, p. 263).

Possessing a clear understanding of an internal control measure coupled with an understanding on how the internal control impacts other functions of the organization is arguably the desired goal when presenting internal controls to stakeholders. Within the

federal government (and specifically the DoD and DoN), the authors found multiple examples of presenting internal controls. The most common approach is likely through written narratives and guidance such as published directives, instructions, regulations, manuals, standard operating procedures (SOP's), memorandums of understanding (MOU's) and alike. The majority of federal government documents reviewed regarding internal control systems and programs (such as OMB Circular A-123, DoD Directive 5010.38, DoD Instruction 5010.40, and SECNAVINST 5200.35D) did not use flowcharts as a method of presenting internal control processes. The above section is applicable since the authors' review the material contained within the MIC manual and assesses how it is presented. Assessing how the MIC manual presents material will assist the authors in determining the manual's ease of use and application throughout the DoN.

#### **F. INTERNAL MANAGEMENT CONTROL SYSTEMS**

“Internal Controls (IC's) and Internal Management Controls (IMC's) are considered synonymous” (SECNAVINST 5200.35E, 2006, p. 1). The purpose of identifying IC's and IMC's as being synonymous is to facilitate a comprehensive understanding of what IMC systems are, and what they are designed to accomplish. There are numerous situations and possible applications, which require IMC's and IMC systems; as are the types and terms used to identify them. For example, the terms Business Intelligence (BI), Business Activity Monitoring (BAM), Enterprise Decision Management (EDM), Enterprise Metrics Management (EMM) and Balance Score Card are examples of IMC systems.

These IMC systems share philosophies for identifying specific tasks or functions that require IC's and define how to effectively institute IC's as part of the larger system. Poor planning and implementation of management systems fail to link financial systems, resources allocation, budgeting, process improvement programs, and long-term strategies. To minimize the potential gaps in effectively implementing an IMC system, Kaplan and Norton recommend using the Balance Scorecard as a Strategic Management System. The

Balance Scorecard not only describes processes for managing strategy, but also facilitates the effective implementation of IMC systems (Kaplan & Norton, 1996). The four processes for managing strategy that Kaplan and Norton discuss are:

- Translate the Vision - For people to act on the words contained in the vision strategy statement, the statements must be expressed as an integrated set of objectives and measures, and be agreed upon by all senior executives that describe the long-term drivers for success.
- Communicating and Linking – This function lets managers communicate their strategy up and down the organization and link it to departmental and individual objectives.
- Business Planning – This function enables companies to integrate their business and financial plans. This is an important concept because most organizations have separate procedures and organizational units for strategic planning and for resource allocation and budgeting.
- Feedback and Learning – This gives companies the capacity for strategic learning. Most companies today operate in a turbulent environment with complex strategies... In an environment where new threats and opportunities arise constantly, companies must be capable of learning through feedback. (Kaplan & Norton, 1996, p. 1-3)

According to Kaplan and Norton, the four processes are characteristics of successful IMC system because the system establishes a “link to a company’s long term strategy with its short term actions” (Kaplan & Norton, 1996, p. 1). Successful IMC systems are designed to give the necessary tools to the entire enterprise and increase corporate understanding. In order to facilitate a successful IMC program, it is imperative for organizations to achieve both successful alignment of existing IMC’s as well as gain corporate buy in (Green & Ryan, 2005, p. 45). Ultimately, “the intrinsic knowledge or the collective intelligence of the people within a business enterprise is believed to be the largest asset,” (Green & Ryan, 2005, p. 44).

#### **G. INTERNAL MANAGEMENT CONTROL SYSTEM EFFICIENCY**

Incorporating the five key components that determine the effectiveness of IC, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission introduced a model or framework designed to assist organizations in the review, evaluation and improvement of their IMC systems (Steinberg & Tanki, 1993, p. 1). In

September 1992, COSO released a report titled “Internal Control - Integrated Framework.” The purpose of this report was to “present a common definition of internal control to meet the needs of diverse users and provides a framework against which entities can assess and improve their internal control systems” (Steinberg & Tanki, 1993, p. 1). According to the COSO report, the internal control integrated framework concept is based on the following premises:

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is not merely documented by policy manuals and forms. Rather, it is an action put in to play by people at every level of an organization.
- Internal control can provide only reasonable assurance, not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories. (Whittington & Pany, 2007, p. 247)

These premises make up the foundation on which COSO’s integrated framework can be used to provide a sound basis for establishing internal control systems and determining their effectiveness (Applegate & Wills, 1999). Additionally, these premises can assist management in gaining firmer control over an organization's activities (Steinberg & Tanki, 1993, p. 2). The report goes even further by providing a standard to which an IMC system can be measured for effectiveness:

The effectiveness of an internal control system is measured by its capacity to provide reasonable assurance to the board of directors and management that these three objectives have been met; effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations. (Simmons, 1997, p. 69)

Although the COSO framework is not the only model available to evaluate and analyze an IMC system, it has been referenced by the PCAOB and SEC as providing an example of an IC system as required by sections 302 and 404 of SOX, (Bizmanualz, 2008). In short, the framework helps ensure that the alignment of IC controls with the larger system remains a continual, evolutionary process; a benchmark which the authors of this text use to analyze the MIC manual.

## **H. SUSTAINING INTERNAL CONTROLS AND SYSTEMS**

In order to sustain internal controls, an organization's management and leadership must first possess the desire and dedication in giving internal controls the attention it requires. Bresnahan (2007) argues that sustaining internal controls requires the organization possess a unique structure. This structure involves the following characteristics.

- That the organization have an effective internal control program
- Focused and flexible leaders
- Flexible in changing controls to the changing environment
- The ability to respond adequately to updates, testing, and remediation
- Continual planning (e.g., to identify risk, allocate resources)
- Ability to assess and determine effectiveness of assessment process
- Possess a proactive cultural mindset (Bresnahan, 2007, pp. 45-48)

According to Bresnahan, "OMB's new rules are clear that management must be proactive in determining that controls are effective," (Bresnahan, 2007, p. 45). Bresnahan also states that prior to OMB's new rules, there existed a lack of concern for sustaining internal controls. Specifically, "before FY 2006, internal control monitoring in many federal agencies was a paper exercise, hastily conducted at the end of each fiscal year. Now, many agencies have come into compliance with tough new rules for controls over financial reporting," (Bresnahan, 2007, p. 45). Bresnahan alludes to the importance of attaining buy-in from senior leadership as well as senior management being proactive with respect to sustaining internal controls. Without continued focus and support from senior leadership in dealing with internal controls, Bresnahan warns of loss in sustainment structure (Bresnahan, 2007).

In 2006, Candreva published an article, which focused on reviewing and interpreting the revised OMB Circular, A-123 (2004). Candreva expressed the importance of an organization having not only adequate internal controls in place, but that an organization should also implement, monitor, and sustain controls throughout the organization. Additionally, Candreva placed emphasis on management's obligation to



maintain internal controls (for the purpose of attaining organizational objectives), and the responsibility of “self-assessing, correcting, and reporting on the efficacy of those controls. In short, controlling the internal controls is the new standard” (Candrea, 2006, p. 1).

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## **IV. THE MIC MANUAL**

### **A. DESCRIPTION**

The purpose of this chapter is to provide an overview of the Department of the Navy Managers' Internal Control (MIC) Manual; primarily on the document's structural organization and content. By reviewing the content and structure of the MIC manual, the authors of this report intend to provide the reader with adequate background knowledge necessary to understand the follow-on discussions in upcoming chapters.

Revised in June 2008, the MIC manual is a 45 page document that is published by the Assistant Secretary of the Navy, Financial Management and Comptroller (ASN(FM&C)). This manual consists of a foreword from the ASN(FM&C) which implements the immediate use of the manual to all applicable Offices of the Secretary of the Navy, the Chief of Naval Operations, the Commandant of the Marine Corps, and all Navy and Marine Corps activities, commands, installations, ships, and stations (SECNAV M-5200.35, 2008). The manual specifies procedures for implementing an effective internal control program throughout the DoN and states that it serves as management's basis for the DoN's annual Statement of Assurance (SOA) to the SECDEF (SECNAV M-5200.35, 2008).

The MIC manual is revised every year and is designed to assist DoN Organizations in the implementation of policy set forth in Department of Defense Instruction (DoDI) 5040.40 Managers' Internal Control (MIC) Program Procedures; and as outlined in SECNAVINST 5200.35, DON MIC program (DoDI 5040.40, p. 1). The stated intent was to develop the manual into a product which provided DoN organizations the necessary tools in establishing and executing an effective internal control program and to specify the procedures required to properly institute, review, assess, and report on the effectiveness of their program's internal controls (DoDI 5040.40, p. 2).

The MIC manual lists a table of contents, an introduction to the DoN MIC Program, and a MIC program overview identifying the DoN Major Assessable Units (MAU's), Senior Management Council, Senior Assessment Team (SAT), and Assessable Units. The MIC program overview explains the program's organizational unit structure, associated areas of responsibility, accountability; and applicable reporting requirements for each level of management responsible for an IC system.

On page 10 of the document, the MIC manual begins to describe the MIC Program documentation requirements that must be maintained by MAU's and their immediate subordinates. These requirements include generating and maintaining risk assessment documentation, control assessment documentation, a corrective action plan, and an overall Managers' Internal Control (MIC) plan (SECNAV M-5200.35, 2008). The MIC plan "captures the organization's approach to implementing an effective internal control program and serves as the first resource MIC coordinators use to understanding their organization's program" (SECNAV M-5200.35, 2008, p. 16). It is within this section of the MIC manual that the GAO's standards for IC's in the federal government (e.g., control environment, risk assessment, control activities) are first listed.

The MIC manual then focuses on Statement of Assurance (SOA) concerns by outlining the required reporting periods as well as discussions surrounding how materiality can be determined. Additionally, the section titled SOA lists 16 different categories in which internal control reporting must occur within the DoD. Procurement, supply operations, financial statement reporting, resource management, and information technology are a few of the categories requiring internal control reporting (SECNAV M-5200.35, 2008).

Approximately half way through the manual, an explanation of the process of submitting annual certification statements by MAU's is provided. Titled *Statement of Assurance Tool*, this portion of the manual illustrates how coordinators of MAU's are required to submit certification statements electronically through the SOA online tool. Access to the SOA online tool is currently restricted to the DoN's 18 MAU's, valid coordinators, and the DoN MIC coordinator. Therefore, no assessment of the SOA online tool was conducted. According to the manual however, using the SOA online tool as a

method of reporting facilitates access to historical data, enables commands to self-report weaknesses and accomplishments, and fosters communication up and down the chain of command (SECNAV M-5200.35, 2008). The SOA online tool enablers (access to historical data, the reporting of weaknesses and accomplishments, and increased communication) are required tasks for MAU's and their subordinate units as outlined in SECNAVINST 5200.35E (SECNAVINST 5200.35E, 2006, pp. 5-9)

Following the Statement of Assurance Tool section of the manual, there are more than 10 pages dedicated to properly preparing and submitting a MIC certification statement. According to the MIC manual, five items are included in the online submission of the MIC certification statement. These include:

1. A cover memorandum
2. A listing of accomplishments
3. A listing of material weaknesses, reportable conditions, and items to be revisited, uncorrected and corrected
4. A listing of uncorrected material weaknesses, reportable conditions, and items to be revisited
5. A listing of corrected material weaknesses, reportable conditions, and items to be revisited (SECNAV M-5200.35, 2008)

The manual further breaks down each item listed above, providing not only examples but by also providing details on the recommended formatting and submitting processes. Concerning the cover memorandum for example, the manual identifies whom the memorandum is addressed to, who authors the document, and lists the mandatory contents that are required to be contained within the memorandum. The MIC manual also requires the cover memorandum to contain a reasonable assurance statement that reflects whether internal controls are both in place and effective. Finally, the cover memorandum must contain a statement, which details the results as either qualified, unqualified, or of no assurance (SECNAV M-5200.35, 2008).

Towards the latter part of the manual, there are additional SOA submission instructions as well as an explanation and instructions for participating in online training through the Navy Knowledge Online website. The manual offers two types of online training. These training courses include a 5-hour course (designed for coordinators and

alternates) on the DoN MIC Program and a 2-hour DoN MIC training program that is specifically designed for managers. At the end of the manual, a listing of common acronyms associated with the MIC manual and a summary of major changes and technical corrections are provided (SECNAV M-5200.35, 2008). Additionally, there are flowcharts, diagrams, and tables throughout the risk assessment and control assessment sections of the MIC manual providing visual aids to help comprehend the material.

As discussed in Chapter II, the FMFIA act of 1982 requires all DoD agencies to assess their IC systems and controls in accordance with the standards and requirements as outlined in OMB circular 123, Appendix A. The DoN's annual Statement of Assurance (SOA), which is prepared and submitted by ASN(FM&C), must also attest to the level of compliance by all DoN organizations. A method for all DoN MAU's and their immediate subordinates to comply with the FMFIA overall process is to maintain all MIC program documentation as presented in this chapter (SECNAV M-5200.35, 2008, p. 10).

## **V. EVALUATION OF THE MIC MANUAL**

### **A. ESTABLISHING THE REVIEW PROCESS**

To determine if the MIC Manual is effective in aligning an organization's current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts and improvement programs, it is necessary to establish that the manual represents the spirit and intent of SECNAV 5200.35E and other pertinent statutory and regulatory references. Additionally, in order to establish the ease of use, comprehension, and implementation of the MIC manual by agencies within the DoN, the authors evaluate how the manual is organized, consider its content, and analyze its thoroughness and effectiveness in incorporating pertinent statutory and regulatory references. Finally, this review process discusses the existence of potential challenges in applying the internal management control concepts as outlined in the present MIC manual.

As previously stated in Chapter III, GAO's Standards for Internal Control in the Federal Government and Whittington and Pany's discussion on components were central to the analysis in this chapter. The purpose of that discussion was to validate the government's use of the five standards as a sound model for evaluating internal control and internal control systems. Whittington and Pany's model clearly defined monitoring to include the monitoring of the overarching systems or programs of internal controls whereas the GAO model falls short in addressing the monitoring of internal control systems or programs. The GAO model fell short by definition not by function.

The five *standards* contained within GAO's Standards for Internal Control in the Federal Government are based on the COSO framework. Also, the five *components* of internal control as outlined by Whittington and Pany are based on the COSO framework. COSO's integrated framework has been determined to be a sound basis for establishing internal control systems and determining their effectiveness (Applegate & Wills, 1999). Since the GAO model is based on the COSO framework and COSO's framework was determined by Applegate and Wills to be a sound basis evaluating internal control systems, the GAO model should be a sufficient tool for use in evaluating internal controls

and systems of internal control. The authors, therefore, argue that the GAO model is designed to evaluate internal controls and also has the necessary attributes to evaluate an internal control system. By analyzing the lineage of the GAO's standards for internal control, coupled with GAO discussion points, which describe internal control as "a major part of managing an organization" (GAO/AIMD-00-21.3.1, 1999, p. 1), in the author's view, it is logical and prudent to evaluate the MIC manual using GAO standards of internal management control. Additionally, the FMFIA tasked GAO with developing and issuing standards for internal control within the federal government (OMB; FMFIA, 1982), and that OMB first issued Circular A-123 in anticipation of FMFIA becoming Law, (GAO, 2005, p. 3). The SECNAVINST 5200.35E was then written for the purpose of meeting the requirements as set forth by OMB Circular A-123 and the FMFIA.

In order to evaluate the MIC manual with an organized and systematic approach, GAO's Internal Control and Evaluation Tool was used. Discussed in Chapter I, the *Evaluation Tool* was published in 2001. The publication provided "a systematic, organized, and structured approach to assessing the internal control structure" (GAO-01-1008G, 2001, p. 1). The tool was written after, and corresponds with, the five standards for internal control published by GAO in 1999. The GAO tool was found by the authors to connect all pertinent regulations and policies because it considered the following legislation: OMB Circular, A-123, the Federal Managers' Financial Integrity Act (FMFIA) of 1982, the Government Performance and Results Act (GPRA) of 1993, the Chief Financial Officers Act of 1990, and Federal Financial Management Improvement Act (FFMIA) of 1996 (GAO-01-1008G, 2001).

The GAO tool is the primary document for this evaluation because it aligns with *Standards for Internal Control in the Federal Government*; which mirrors COSO and the components as outlined within the Whittington and Pany text. Using this GAO tool, the MIC manual can be assessed for completeness, thoroughness, and appropriateness in addressing each of the five standards. The GAO tool provides a formatted structure for evaluating IC's based on the five standards of internal control by providing a checklist of "Major Factors," "points," and "subsidiary points" that correspond with the five standards. Appendix B provides a detailed list of all major factors, points, and subsidiary



points as listed within the GAO tool. This structure is followed by the authors of this report throughout the remaining analysis of the MIC manual (GAO-01-1008G, 2001).

## **B. STANDARDS OF CONTROL**

The initial review of the MIC manual revealed that it was not developed or directly based upon the five standards of internal control or GAO report (GAO/AIMD-00-21.3.1, 1999). The MIC manual does not identify GAO's five standards for internal control until page 17 of the 44-page document. The MIC manual's discussion surrounding the five standards is limited. The manual lists the five standards, recommending the standards be used in developing a MIC plan, and provides a link to the GAO website in order to obtain additional information. Since the five standards of internal control have been stated by GAO as "the minimum level of quality acceptable for internal control in government and provide the basis against which internal control is to be evaluated" (GAO/AIMD-00-21.3.1, 1999, p. 7), the authors are of the opinion that the MIC manual should expand upon the presentation of the five standards of internal control.

### **1. Control Environment Assessment**

#### ***a. Integrity and Ethical Values (Major Factor #1)***

Using the GAO tool to evaluate the first standard (i.e., the control environment) it became apparent that few of the main points listed under the first major factor (i.e., integrity and ethical values) were adequately contained within the MIC manual. For example, the GAO tool suggests assessing whether cooperation among managers, auditors, and evaluators is encouraged in an ethical manner. Although the MIC manual contained terminology that urged and encouraged managers to cooperate with auditors, the discussion was not ethics-based.

In using the same GAO tool, the MIC manual (as a whole) falls short in containing terminology, which sets a positive and supportive attitude toward IMC; a major factor under the control environment standard that fosters IMC effectiveness.

Although the MIC manual states that it “implements the policy set forth in SECNAVINST 5200.35E” (SECNAV M-5200-35, 2008, p. 2), the manual does not communicate to the authors the importance of integrity and ethical values as it pertains to IMC’s and the control environment. Any positive ethical tone that is being sought within government agencies with respect to IMC’s is not evident in the MIC manual. Two other areas under the control environment, which the MIC manual does not address, are 1) the absence of contact information for submitting questions, suggestions, or recommendations to the overall process, and 2) consideration of disciplinary action controls should an organization or individual fail to implement the tasks as outlined in the manual. Additionally, the potential for management override involving internal control reporting as designed in the MIC manual could be a material weakness within the program and manual itself. The whole concept of identifying, monitoring, improving, correcting, strengthening, and reporting internal control deficiencies within the MIC manual is largely based upon the self-reporting of control deficiencies. According to the MIC manual, “This self-reporting of control deficiencies enables commands to demonstrate effectiveness of their control environments and activities, and indicate the findings of their control assessments,” (SECNAV M-5200-35, 2008, p. 5). Although the concept of self-reporting control deficiencies can be viewed as a measure of effectiveness and mode of identifying findings, the potential for managers to intentionally not-report identified internal control weaknesses that surface is a concern. The concept of self-reporting is not an inherent risk but rather a substantial control risk which by design, limits the effectiveness of the control environment through the use of the MIC manual. The one method which strengthens the control environment standard within the MIC manual as it pertains to the reporting of deficiencies involves a quarterly meeting with the Naval Audit Service (NAVAUDSVC) wherein audit reports from the GAO, DoD Inspector General (IG), and NAVAUDSVC are reviewed (SECNAV M-5200-35, 2008, p. 5). In these cases, where audits have been conducted, the potential for management override in reporting all noted discrepancies is mitigated to a large degree.

***b. Commitment to Competence (Major Factor #2)***

Commitment to Competence is the next major factor within the GAO tool that can be used for measuring the control environment. In assessing the MIC manual, all of the “points” and “subsidiary points” listed in the GAO tool under commitment to competence are satisfied. The MIC manual adequately identifies and defines required positions and tasks. The manual also defines the responsibilities of key personnel, presents the overall structure of the program, and clearly states the training requirements for coordinators, alternates, and others alike. Additionally, the MIC manual presents the availability of computer-based training for not only those who wish to receive an overview of the DoN MIC Program, but also online training for managers within the federal government. The Managers’ Internal Control Training portion of the MIC manual both explains the content, objectives, and applicability of the computer-based training as well as lists step-by-step instructions and print screen-shots in order to ensure readers can access the online training. Unlike the DoN Managers’ Internal Control Program website ([http://www.fmo.navy.mil/mic/home\\_index.htm](http://www.fmo.navy.mil/mic/home_index.htm)) however, the MIC manual does not list the GAO tool as an enabler for managers to assess IC’s. In this area, the manual itself provides less knowledge than the MIC Program website to lower management who might otherwise need this material to strengthen their skills and abilities in identifying weak IC’s.

***c. Management Philosophy and Operating Style (Major Factor #3)***

Management’s Philosophy and Operating Style is the next major factor within the GAO tool that can be used for measuring the control environment. For the evaluation of whether the MIC manual projected a management philosophy and operating style that was consistent with the GAO tool and one which adequately developed effective internal controls, there were mixed results. The submittal of certification statements through the online Statement of Assurance Tool was a positive operating style because it safeguards information by use of the online submission tool. The manual also supported a positive operating style in that it promoted the use of the SOA tool “as a means of communication, allowing units / users to communicate up and down their

respective chains of command” (SECNAV M-5200-35, 2008, p. 25). Finally, the MIC manual promotes using performance-based metrics and other assessments to monitor IC’s, something that the GAO tool identifies as a key element to possess within an organization’s operating style (GAO-01-1008G, 2001, p. 13).

However, in using GAO’s tool to assess the manual, one might view the MIC manual as being deficient in communicating an overall vision or management philosophy. The manual simply does not list a management vision or philosophy in the body of the manual. Another subsidiary point under management’s philosophy and operating style within the GAO tool is to consider whether personnel submit inappropriate or inaccurate reports in order to meet targets, (GAO-01-1008G, 2001, p. 15). As discussed in the first major factor, the control environment of the MIC manual is weakened under the management philosophy and operating style because there is no method of measuring deficiencies that have gone unreported under the self-reporting method.

*d. Organizational Structure (Major Factor #4)*

Organizational Structure is the next major factor within the GAO tool that can be used for measuring the control environment. The MIC manual exhibited strengths in possessing a sound organizational structure, which was consistent with the content of the GAO tool. The MIC manual clearly outlines the DoN SOA flow of information up and down the chain of command. Figures depicting the various levels of the organizational structure are contained within the MIC manual and reflect the top-down, bottom-up flow process. These figures are useful for visualizing the organizational structure and can be used as templates for learning the structure. The GAO tool also recommends measuring the soundness of organizational structure by assessing the level of focus on key areas of authority and responsibility. Again, the MIC manual identifies those who possess authority and outlines the responsibilities of the ASN(FM&C), NAS, Major Assessable Units (MAU’s), the Senior Management Counsel, the Director, Office of Financial Operations (FMO), the Senior Assessment Team, Assessable Units (AU’s), coordinators, alternates, and auditing agencies (SECNAV M-5200-35, 2008, p. 5-25).

Lastly, the MIC manual has established clear reporting relationships as outlined within the GAO tool. All remaining elements under the GAO tool's organizational structure were not applicable in the assessment of the MIC manual. For example, determining whether employees work excessive overtime or whether an employee fills more than one role was simply found to be inapplicable. Note that evaluators are encouraged to tailor the GAO tool to meet the needs of an IC assessment (GAO-01-1008G, 2001, p. 15).

*e. Assignment of Authority and Responsibility (Major Factor #5)*

The Assignment of Authority and Responsibility is the next major factor within the GAO tool that can be used for measuring the control environment. The MIC manual supports a high level of authority and responsibility at the lower levels of management. The self-reporting of deficiencies by managers up the chain of command greatly empowers managers to correct problems or implement improvements as described in the GAO tool (GAO-01-1008G, 2001, p. 17). The potentially adverse effect resulting from such empowerment and authority in the self-reporting method has already been discussed.

One element of the GAO tool seeks to measure whether “the agency appropriately assigns authority and delegates responsibility to the proper personnel to deal with organizational goals and objectives” (GAO-01-1008G, 2001, p. 17). When applied to the assessment of the MIC manual, the overarching goal and objective of the manual itself does not appear to be clearly stated. Rather, the goal “to maintain internal control assessment documentation that gives managers the information they need to establish and improve internal controls within their command” (SECNAV M-5200-35, 2008, p. 15) is one of the two stated goals within the MIC manual and refers to the importance of controlling assessment documentation. The second stated goal pertains to risk assessment and is discussed in 2.a. of the following section of this paper. It remains unclear as to whether the objective of the MIC manual is to comply with regulatory and statutory material, strengthen internal controls or systems, or to be used as an informational tool on how to properly complete a certification statement and submit the data via the SOA online tool.

*f. Human Resource Policies and Practices (Major Factor #6)*

Human Resource Policies and Practices are the next major factor listed within the GAO tool as measures for the control environment. Under this section, the GAO tool recommends considering whether “Employees receive guidance, review, and on-the-job training from supervisors to help ensure proper work flow and processing of transactions and events, reduce misunderstandings, and discourage wrongful acts” (GAO-01-1008G, 2001, p. 19). Guidance on proper workflow and processing of the SOA is provided within the text of the manual. However, the manual does not require on-the-job training from supervisors.

*g. Oversight Groups (Major Factor #7)*

Oversight Groups are the last major factor listed within the GAO tool as measures for assessing the control environment. The GAO tool suggests that a control environment is sound if an independent auditor such as an Inspector General (IG) audits and reviews agency activities. Additionally, the GAO tool indicates that close coordination among audit committee members and executives of the organization facilitate a sound control environment (GAO-01-1008G, 2001, p. 20). The MIC manual states that audits are conducted by independent agencies such as the IG and that close coordination should exist among those involved in the MIC manual process.

**2. Risk Assessment**

To assess risk, the second internal control standard, the GAO tool lists five major factors for consideration. These factors are: establishment of entity-wide objectives, establishment of activity-level objectives, risk identification, risk analysis, and managing risk during change. Although the GAO tool identifies these five factors as a good starting point to assessing risk, the GAO tool contains terminology, which stresses that the factors are not all-inclusive and may not apply under certain circumstances. The GAO tool also emphasizes that establishing clear and consistent goals and objectives at both the entity and agency levels are a precondition to initiating any risk assessment (GAO-01-1008G, 2001, p. 23).

***a. Establishment of Entity-wide Objectives (Major Factor #1)***

In applying the GAO tool, the MIC manual does not list entity-wide objectives. The MIC manual lists a stated goal on page 11, but the goal pertains to the completion of a risk assessment. With regard to organizational objectives however, the overarching organizational goals and objectives that have been established by management pertaining to risk and the goal of the internal control program/manual have not filtered down and are not clearly stated within the manual. As discussed in Chapter II, the GPRA of 1993 required agencies to clarify goals and objectives in order to improve the efficiency of a program.

***b. Establishment of Activity-Level Objectives (Major Factor #2)***

In applying the GAO tool, it is important to assess whether the activity-level objectives complement one another, include measurement criteria, and link with the organization's entity-wide objective and strategic plans (GAO-01-1008G, 2001, p. 24). This can be assessed by comparing mission-level objectives with entity-wide objectives and ensuring that the objectives are both relevant and properly linked to one another. Because the entity-wide objectives are not clearly stated within the MIC manual, evaluating activity-level objectives as they relate to the entity cannot be accomplished.

***c. Risk Identification (Major Factor #3)***

The MIC manual provides methods for identifying internal risk. In comparing the MIC manual with the GAO tool, the MIC manual contains considerations that are the same as those which are outlined in the GAO tool. Specifically, the manual identifies the three types of risk and provides an explanation of each, while also listing a decision diagram to distinguishing between inherent, control, and combined risk. As discussed in the GAO tool, the manual also uses both qualitative and quantitative methods for identifying risk. The MIC manual contains a sample flowchart for documenting key processes, as well as tables for measuring inherent, control, and combined risk as being either low, moderate, or high (SECNAV M-5200-35, 2008, pp. 10-14). Although the manual also explains how risks are to be identified, ranked, analyzed, and reported, it

does not distinguish risk as emerging from either internal or external factors. Discussions involving risk are focused on internal factors and the MIC manual does not provide mechanisms for managers to use in considering risk from external sources; it is something, which the GAO tool lists as a major factor.

***d. Risk Analysis (Major Factor #4)***

Risk Analysis is the next major factor within the GAO tool that can be used for measuring and assessing risk. Consistent with the GAO tool, the MIC manual exhibits a formal process for analyzing risk and assigning levels of risk as being high, moderate, or low once risk has been identified. As part of the risk analysis process, the MIC manual contains a risk assessment table wherein an organization can assign a control number to an identified risk, categorize the risk level as high, moderate, or low, and indicate whether inherent, control, or combined risk exists. Additionally, the risk assessment table contains a column for listing the internal control that is currently in place for the risk identified (SECNAV M-5200-35, 2008, pp. 10-14). The last point under the major factor of risk analysis contained in the GAO tool asks whether “management has developed an approach for risk management and control based on how much risk can be prudently accepted” (GAO-01-1008G, 2001, p. 29). The MIC manual addresses this concern through the use of a control assessment table which is designed to validate the assumed level of control risk by an organization (SECNAV M-5200-35, 2008, p. 15).

***e. Managing Risk during Change (Major Factor #5)***

Managing Risk during Change is the final major factor within the GAO tool that can be used for risk assessment. The MIC manual addresses this factor through the regular requirements of preparing and submitting control assessment documentation. The MIC manual states that “once internal controls are in place; management shall actively monitor those controls to ensure they are functioning correctively and effectively mitigating the associated risk” (SECNAV M-5200-35, 2008, p. 14). The MIC manual recommends that major units submit at least one internal control assessment annually to



monitor potential changes. Additionally, since there is a requirement to update the MIC manual on an annual basis, any statutory or regulatory changes that might occur throughout the year would be addressed within the updated manual.

### **3. Control Activities**

Only those major factors, which were found to be pertinent or applicable in assessing the MIC manual, are discussed below.

#### ***a. General Application (Major Factor #1)***

When comparing the MIC manual to items listed under this category, the GAO tool considers whether “appropriate policies, procedures, techniques, and mechanisms exist” (GAO-01-1008G, 2001, p. 34). Although the MIC manual does reference DoDI 5010.40, SECNAVINST 5200.35E, SECNAVINST 5430.7N, GAO’s standards for internal control, and OMB Circular A-123 as related internal control sources, the manual does not mention the relevance, interrelation, and value of the GPRA, DoD Directive 5010.38, and the GAO’s tool. Although not specifically identified as control activities, the MIC manual does identify several activities surrounding the submission of certification statements and SOA’s that are viewed as a form of control.

#### ***b. Common Categories of Control Activities (Major Factor #2)***

In this category, when comparing the MIC manual to items listed in the GAO tool, the manual tracks an organization’s (submitted) initiatives, achievements, and deficiencies while also ensuring corrective action is taken where necessary. This is accomplished through the MIC manuals SOA reporting process. The manual also contains control activities to ensure that those who are involved in the SOA submission process receive proper online training. With regard to other points under this section contained in the GAO tool, the MIC manual does not have a section dedicated to control activities. The manual neither defines nor explains control activities to the level that one could determine the adequacy of internal controls and to what level they should be controlled. Rather, the MIC manual provides a few examples of various control activities

within a flowchart, stating that “the flowchart will identify key processes and their related control activities such as control over information processing, physical control over vulnerable assets, segregation of duties, and accurate and timely recording of transactions and events, (SECNAV M-5200-35, 2008, p. 12). Another section within the MIC manual (developing a MIC Plan) states that the MIC plan will address all five elements of the GAO standards. In this example of a MIC plan, there is a section on control activities which instructs the reader to “Describe the methodology of how control activities are identified and developed, the types of policies and documented procedures that are in place to explain and outline how to ensure the effectiveness of controls” (SECNAV M-5200.35, 2008, p. 19). Neither section, however, provides the information necessary for the individual to be able to understand the importance of control activities. The reader is however, provided a list of GAO’s standards of internal control and directed to the GAO online website for additional information.

***c. Control Activities Specific for Information Systems – General Control and Application Control (Major Factors #3 through 10)***

Information technology (IT) is included as an internal control reporting category within the MIC manual. The manual describes this area as covering “the design, development, testing, deployment, use, and security of automated information systems using a combination of computer hardware, software, or data that performs functions such as collecting, processing, storing, transmitting, or displaying information and other technologies for processing management information” (SECNAV M-5200.35, 2008, p. 24). The MIC manual does not state that control activities should be assessed in each one of these areas within IT. Rather, it is implied that each area within IT be assessed under the control activity. The MIC manual does not provide the level of detail which the GAO tool does in assessing access control, system software control, segregation of duties, service continuity, authorization control, completeness control, accuracy control, or control over integrity of processing and data files as it pertains to information technology (GAO-01-1008G, 2001).

#### **4. Information and Communications**

##### ***a. Information (Major Factor #1)***

Using the GAO tool to evaluate the fourth standard (Information and Communication) the MIC manual addresses all but one sub-category within the information factor. The MIC manual establishes mechanisms (SOA) online tool, tables, charts, and figures to capture and record operational information pertaining to internal controls. The manual also provides the reader with various sources of training as well as other items of interest and relevance regarding the submission of certification statements. The MIC manual does not however, provide an in-depth description or explanation of GAO's five standards of internal control or provide the reader with the tools necessary for assessing each of the five standards. A consideration listed under the information factor within the GAO tool involves identifying whether "Pertinent information is identified, captured, and distributed to the right people in sufficient detail, in the right form, and at the appropriate time to enable them to carry out their duties and responsibilities efficiently and effectively" (GAO-01-1008G, p. 51). In the author's view, an in-depth description and explanation of the GAO's five standards of internal control is pertinent information which the MIC manual does not provide.

##### ***b. Communications (Major Factor #2)***

Communication is the next major factor within the GAO tool that can be used for measuring the information and communications standard. In assessing the MIC manual, most of the points and subsidiary points listed in the GAO tool under communication are satisfied. The MIC manual clearly communicates the SOA submission requirements and the duties of key personnel. Additionally, the manual lays the foundation for communication among internal organizations throughout the reporting process as well as external agencies such as auditors from the GAO or IG.

**c.       *Forms and Means of Communication (Major Factor #3)***

Forms and Means of Communications is the last major factor within the GAO tool that can be used for assessing the information and communication standard. The MIC manual, a form of communication in itself, also provides other forms of communication such as phone numbers and email addresses to obtain additional information on internal control. The manual also provides the DoN's MIC webpage ([http://www.fmo.navy.mil/mic/home\\_index.htm](http://www.fmo.navy.mil/mic/home_index.htm)) as a source for communicating any changes or updates pertaining to the MIC program and manual.

**5.       Monitoring Assessment**

**a.       *Ongoing Monitoring (Major Factor #1)***

Using the GAO tool to evaluate the fifth standard, several forms of monitoring are observed throughout the MIC manual. The manual states that "Monitoring of internal controls shall include policies and procedures for ensuring that the findings of audits and other reviews are promptly resolved" (SECNAV M-5200.35, 2008, p. 16). External to the MIC program and manual are audits by the GAO and IG, which act as an ongoing monitoring tool. Additionally, deficiencies that are identified as a material weakness, a reportable condition, or an item to be revisited as outlined in the MIC manual are all conditions, which enable ongoing monitoring of internal controls throughout the reporting process. The Managers' Internal Control Plan, a plan required by the MIC manual, is also a mechanism for monitoring corrective actions, training efforts, changes in the organizational structure, and changes of key positions. The SOA submission process also acts as a form of ongoing monitoring since actions are taken to ensure the deficiency is resolved in a timely manner.

**b.       *Separate Evaluations (Major Factor #2)***

Discussions within the GAO tool suggest considering the frequency in which separate evaluations of internal control occur and assessing whether the methodology for evaluating the organization's internal control is logical and appropriate

(GAO-01-1008G, p. 63). The authors have discussed that external evaluations and audits occur through the GAO and IG, although the frequency and adequacy in which these evaluations occur is unknown. Concerning the MIC manual's methodology in evaluating the organization's internal control, the negative impacts of self-reporting have already been raised. It is for this reason that one could argue the methodology for evaluating internal control is not appropriate. Additionally, neither the GAO tool nor MIC manual incorporates any monitoring of the internal control system, only internal controls within the system.

*c.      **Audit Resolution (Major Factor #3)***

Where applicable, the MIC manual supports, encourages, and requires prompt action and resolution to the discovery of an internal control deficiency. The MIC manual has a corrective action plan and requires a narrative be included in the SOA submission pertaining to the resolution of any negative audit finding. Training that is provided under the MIC program and manual also contain discussions surrounding the importance of being responsive to any noted discrepancies and developing solutions to an identified internal control issue. Finally, senior leadership is supposed to be involved in reviewing SOA submissions for completeness, ensuring that appropriate actions have been taken in a timely manner (in response to an audit finding) and to provide oversight in ensuring all parties are satisfied with corrections that have been made.

**C.      THE REVIEW PROCESS**

The GAO tool was used to evaluate the MIC Manual to determine if the manual aligns with the spirit and intent of the SECNAV 5200.35E and other pertinent statutory and regulatory references. The findings of Chapter V are used as the basis for Chapter VI of this evaluation. The following findings will be used to determine the ease of comprehension and implementation MIC manual: 1) its effectiveness in aligning an organizations' current mission, organizational philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs, and 2) the potential challenges in applying the internal management control concepts based on the MIC manual.

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## **VI. CONCLUSION AND RECOMMENDATION**

### **A. IMC SYSTEM FUNCTION**

The situations that require IMC's and IMC systems are many, just as there are multiple ways to contemplate how, or determine why a specific function or task should be controlled. Identifying a specific task is not necessarily complex, but effectively incorporating and implementing the task as part of a IMC system while also considering the organization's philosophy is challenging. The difficulty lies in the intangible aspects of applying an IMC and identifying and using a model that effectively articulates the process. Properly defining IMC's has become increasingly difficult given today's growing environmental diversity, the complexity of organizations, and the increased needs of management. Due in part to the increase in organizational and environmental complexity, IMC's become more complex. As a result, comprehension of these detailed control systems has become more challenging when one has to consider aligning IMC's with management's strategy, goals, organizational philosophy, sustainment programs, laws and regulations.

As discussed in Chapter III, a sound IMC system effectively translates a vision, communicates a strategy throughout the organization, and links the strategy with objectives throughout the organization. An effective IMC system establishes approaches for identifying a specific task or function that requires an IMC as well as defines how to effectively institute IMC's as part of the larger system. Using an IMC system that does not possess a shared organizational philosophy among applicable stakeholders can result in ineffectiveness or failure due to improper alignment and linkage of a shared vision, strategy, or even corporate buy-in. As previously stated, it is imperative for organizations to achieve successful alignment among existing IMC's (in order to facilitate a successful program) as well as gain corporate buy-in (Green & Ryan, 2005, p. 45). To minimize these negative effects, an effective implementation strategy should include an IMC system that offers effective translation yet simplicity.

Successful IMC systems are designed to give the necessary tools to the entire organization and increase corporate understanding. The ability of an organization to clearly define the environment and goals of an IMC system is not only required by law, but should also be viewed as part of the necessary tools which are needed to increase the corporate understanding of managers and other stakeholders. To do otherwise makes improving a program more difficult because key personnel find it challenging to understand the overarching purpose and vision of the program. As previously discussed, GPRA set in motion the requirement to clearly state the goals of a program and measure its performance. This law was enacted based in part upon congressional findings that “federal managers were seriously disadvantaged in their efforts to improve program efficiency and effectiveness, because of insufficient articulation of program goals and inadequate information on program performance” (GPRA of 1993, p. 1). The unfavorable congressional findings listed above can be directly attributed to an instruction, manual, or directive that contains unclear goals, missions, and objectives. In addition to the GPRA, the FMFIA was discussed as legislation which required the control of the defined environment and goals. GAO’s five standards of internal control were developed in response to the FMFIA and have been presented in this report as being designed to link organizational philosophies with pertinent statutory mandates and regulatory concepts. Ultimately, the successful articulation of organizational philosophies and goals within a program’s design, instructions, directives, orders, and manual creates greater corporate understanding for the entire organization.

Reviews of IMC systems or programs are equally important and necessary as conducting a review or audit of internal controls within the system. Throughout the data collection and review process of this report, the authors noted various audits and reports that were conducted; sighting weaknesses of current internal controls of the DoD and DoN. The majority of these audits/reports reviewed focused on shortcomings within various operational controls of an IMC system such as in inventory management, transportation, travel cards, credit cards, improper payment disbursing, and financial management activities. Yet, not one assessment of an overarching IC system or program was identified. There appears to be a willingness to blame deficiencies on poor internal



management controls at the operational level. Although placing the blame on these deficiencies is well-founded and largely substantiated, the root cause in some of these deficiencies may lie on the poor design of the overall program or system.

The absence of focus on assessing IMC systems is arguably one of the shortcomings of the GAO's five standards of internal control, which does not suggest or require the use of the five standards as a monitoring or evaluation tool for both internal controls and internal control programs or systems. Therefore, any organization implementing GAO's five standards of internal control (e.g., control environment, risk assessment, control activities, information and communication and monitoring) into its IMC system could potentially fail to consider the ongoing monitoring of the system or program as imperative. The authors of this report are of the opinion that the GAO model of the five standards of internal control is an effective and efficient tool for both the monitoring of IC's and IC systems or programs. As the GAO states, "Internal control is management control that is built into the entity as a part of the infrastructure to help managers run the entity," (GAO Report 00-21.3.1, 1999, p. 6). One could assert that internal control systems are likewise management controls that are built into an organization's design and help managers run the organization.

The GAO Internal Control Management and Evaluation Tool (GAO tool) was used to evaluate the MIC manual in order to answer the project objectives as discussed in Chapter I. To determine if the MIC manual aligns with the spirit and intent of the SECNAVINST 5200.35E, the functionality of the MIC manual is discussed in section B of this chapter. To identify the ease of use or potential challenges in applying the concepts as outlined in the manual, the alignment of other statutory and regulatory references are discussed in section C of this chapter. Section D, the overall conclusion, discusses the manual's effectiveness in aligning an organizations' current mission, philosophy, management strategy, goals, metrics, sustainment efforts, and improvement programs.

## **B. FUNCTIONALITY OF THE MIC MANUAL**

The MIC manual complies with the responsibilities and requirements as outlined in SECNAVINST 5200.35E. Specifically, the manual provides an internal control reporting structure, due dates, examples, instructions on reporting requirements, and instructions on accessing internal control training. The manual also complies with the SECNAVINST 5200.35E by listing assessable units, the number of scheduled and completed assessments, and progress for accomplishing the annual program (SECNAVINST 5200.35E, 2006, p. 2).

The MIC manual also describes the submission process of certification statements through the statement of assurance (SOA) online tool and defines the responsibilities of those involved in the process. The MIC manual provides guidance on properly assessing and documenting feeder components (such as accomplishments, material weaknesses, reportable conditions, and items to be revisited) of the SOA, as well as documenting and reporting out the results of any external audits that are conducted by the GAO, DoD IG or other agency. However, one could argue that the manual falls short in transcending or translating the organizational philosophy of SECNAVINST 5200.35E. In design, the MIC manual lacks depth in referencing and explaining the importance of IC's, the GAO standards, the GPRA requirements, and other pertinent programs and initiatives. The MIC manual's focus on providing instructional guidance; adhering directly to the requirements of SECNAVINST 5200.35E alone, requires the reader to be fully educated on internal controls and possess knowledge of the spirit and intent of SECNAVINST 5200.35E, the GAO's five standards, the FMFIA, OMB Circular A-123, the GPRA, and other documentation which lay the foundation and requirements for IC's and IMC system functions. Additionally, one could argue that the overarching organizational goals and objectives that have been established by superseding documents have not filtered down and are not clearly stated within the manual.

Lastly, the potential for management override in the self-reporting process by the non-reporting of identified control weaknesses is an impairment to the functionality of the MIC manual. This report does, however, recognize that the self-reporting process is

an accepted control risk that cannot be overcome without implementing a mandated and external audit process of every entity throughout the organization. This alternative is neither cost effective nor realistic given the size of DoD organizations. Therefore, the likely functionality of the MIC manual (and program) is recognized as limited under the control environment because reported information is potentially unreliable due to the absence of material data that was not self-reported.

### **C. RECOMMENDATIONS FOR MIC MANUAL**

The MIC manual is a mechanism for communicating the DoN's MIC Program. Arguably, manuals are only designed to effectively translate how a certain process should be completed. However, the forward states that the MIC manual "specifies procedures for implementing an effective IC program throughout the DoN" (SECNAV M-5200.35, 2008). Therefore, the procedures should include and link the overarching organizational philosophy and goals (of the MIC Program) while also translating the vision and strategy up and down the organizational hierarchy. Additionally, including the control philosophies, objectives, vision, and strategy of the MIC Program within the MIC manual also facilitates understanding and fosters corporate buy-in among managers.

The MIC manual should begin by clearly stating the mission, purpose, goals, and objectives of the manual while transcending the managerial philosophy, intent, and vision of SECNAVINST 5200.35E and other statutory and regulatory documents. Doing so will provide the reader with a background pertaining to IC's and provide an explanation into the importance of IC's and IC programs/systems. Stating the purpose, goals, and objectives clearly will provide the reader with a baseline and understanding of why and how the MIC manual facilitates the strengthening of internal controls while also transcending the importance of internal controls and processes. By also setting a positive and supportive attitude towards IMC's, buy-in from senior leadership, managers, and other stakeholders will be encouraged.

The MIC manual could be improved by using the structure of GAO's five standards of internal control. Although the MIC manual discusses the control environment, risk assessment, information and communication and monitoring, the topics

are not clearly delineated by standard. The manual does not clearly reflect the five standards of internal control throughout the body of the text as standards. The MIC manual should be written as a representation of what an internal management control program should look like, so that readers can have an example of what is a control environment. By using titles such as “The Control Environment,” “Risk Assessment,” “Control Activities” “Information and Communications” and “Monitoring” throughout the MIC manual, the structure of the manual will be better-suited for assimilating and applying the GAO standards and tool which actually helps the reader “determine what, where, and how improvements can be implemented” (GAO-01-1008G, 2001, p. 1).

The MIC manual should encourage managers to place great emphasis on using and applying GAO’s tool when interpreting and understanding the five standards of internal control. Although the MIC manual lists the five standards of control on page 17 of the text, the manual does not identify the GAO’s tool as a valuable mechanism for developing or assessing existing IC’s. The GAO standards are an effective mechanism to maintain or achieve effective internal control.

#### **D. CONCLUSION**

When designed well, IMC systems increase corporate understanding because each member of the organization is provided the necessary tools to understand the requirements of the IC’s within their entity. Additionally, a well-designed IMC system provides stakeholders a holistic understanding of why and how IC’s impact the organization. When a manager clearly understands the IC’s he or she has in place, understands the interrelationship and value of those IC’s as they function among other entities and within the organization as a whole, corporate understanding is strengthened and a firm link between IC’s and the organization’s philosophies, goals, objectives, and strategy has been established.

It is imperative for organizations to achieve both successful alignments of existing IMC’s (in order to facilitate a successful program) as well as gain corporate buy-in (Green & Ryan, 2005, p. 45). The Standards of Internal Management Control are designed to link philosophies with other pertinent statutory and regulatory concepts.

Ultimately, by linking the IMC management philosophies of pertinent regulatory and statutory documents and realigning the format to coincide with the five standards of internal control, the MIC manual can better articulate the necessity for IC's and strengthen its ease of use.

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## **APPENDIX A**

### **A. OTHER STATUTORY AND REGULATORY REFERENCES THAT INDIRECTLY CONTRIBUTED TO THE INFLUENCE OF THE DON'S MIC PROGRAM**

Deputy Secretary of Defense Memorandum, "Establishment of the Senior Financial Management Oversight Council," July 14, 1993

Department of Defense (DoD) 5000.1, "The Defense Acquisition System," May 12, 2003

Department of Defense (DoD) Directive 5118.3, "Under Secretary of Defense (Comptroller) (USD(C))/Chief Financial Officer (CFO), Department of Defense," January 6, 1997

Department of Defense (DoD) 7000.14-R, "DoD Financial Management Regulation," current edition, authorized by DoD Instruction 7000.14, November 15, 1992

Department of Defense (DoD) 8000.1, "Management of DoD Information Resources and Information Technology," February 27, 2002

Department of Defense (DoD) 8910.1-M, DoD Procedures for Management of Information Requirements, November 28, 1986, authorized by DoD Directive 8910.1, June 11, 1993

Federal Accounting Standards Advisory Board (FASAB), Generally Accepted Accounting Principles (GAAP), multiple dates, can be found at <http://www.fasab.gov/accepted.html>

General Accounting Office (GAO) Policy and Procedures Manual for Guidance of Federal Agencies, "Title II Accounting," May 1988

Office of Management and Budget Memorandum A-11, Preparation, Submission and Execution of the Budget, July 16, 2004

Office of Management and Budget (OMB) Bulletin No. 01-09, "Form and Content of Agency Financial Statements," September, 25, 2001

Office of Management and Budget (OMB) Circular A-76, Performance of Commercial Activities, May 29, 2003

Office of Management and Budget Circular (OMB) A-130 (Revised), "Management of Federal Information Resources," November 28, 2000

Office of Management and Budget Circular (OMB) Circular No. A-136, "Financial Reporting Requirements," December 21, 2004

Office of Management and Budget Memorandum, "Year-End Internal Control Report," current edition

Secretary of Defense Memorandum, "Revised Federal Managers' Financial Integrity Act Implementation," February 12, 1994

Secretary of Defense Memorandum, "Guidance to Implement Secretary of Defense Federal Managers' Financial Integrity Act Direction," April 18, 1994

Secretary of Navy Instruction (SECNAVINST) 5430.7N, "Assignment of Responsibilities and Authorities in the Office of the Secretary of the Navy" June 9, 2005

Secretary of Navy Instruction (SECNAVINST) 5214.1, "Department of the Navy Information Requirements (Reports) Manual," December 2005

Section 101 of title 6, United States Code

Section 501 of title 31, United States Code

Section 1101 of title 31, United States Code

Sections 3512 and 3515 of title 31, United States Code (as amended by the Government Management Reform Act of 1994, Public Law 103-356, January 25, 1994

Section 7501 of title 31, United States Code

Statements of Federal Financial Accounting Standards (through 1996 and as issued by Office of Management and Budget)

Statements of Federal Financial Accounting Standards (through 1996 and as issued by Office of Management and Budget)



Treasury Financial Manual, Volume 1: Federal Agencies, United States Department of the Treasury, Financial Management Service, latest version, can be found at <http://www.fms.treas.gov/tfm>

United States Navy Regulations, 1990

United States Standard General Ledger (USSGL), latest version, can be found at <http://www.whitehouse.gov/omb/bulletins/b01-09.html>

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## **APPENDIX B**

### **A. GAO'S INTERNAL CONTROL MANAGEMENT AND EVALUATION TOOL (GAO TOOL)**

Appendix B provides a detailed list of the points and subsidiary points provided in the GAO tool. The GAO tool does define the five standards, however, that portion was removed because Chapter III provided that detail. This structured approach is used to describe overall finding in this report (GAO-01-1008G, 2001).

### **CONTROL ENVIRONMENT**

#### **Integrity and Ethical Values**

**1. The agency has established and uses a formal code or codes of conduct and other policies communicating appropriate ethical and moral behavioral standards and addressing acceptable operational practices and conflicts of interest. Consider the following:**

- The codes are comprehensive in nature and directly address issues such as improper payments, appropriate use of resources, conflicts of interest, political activities of employees, acceptance of gifts or donations or foreign decorations, and use of due professional care.
- The codes are periodically acknowledged by signature from all employees.
- Employees indicate that they know what kind of behavior is acceptable and unacceptable, what penalties unacceptable behavior may bring, and what to do if they become aware of unacceptable behavior.

**2. An ethical tone has been established at the top of the organization and has been communicated throughout the agency. Consider the following:**

- Management fosters and encourages an agency culture that emphasizes the importance of integrity and ethical values. This might be achieved through oral communications in meetings, via one-on-one discussions, and by example in day-to-day activities.
- Employees indicate that peer pressure exists for appropriate moral and ethical behavior.
- Management takes quick and appropriate action as soon as there are any signs that a problem may exist.

**3. Dealings with the public, Congress, employees, suppliers, auditors, and others are conducted on a high ethical plane. Consider the following:**

- Financial, budgetary, and operational/programmatic reports to Congress, OMB, Treasury, the Office of Personnel Management (OPM), and the public are proper and accurate (not intentionally misleading).

- Management cooperates with auditors and other evaluators, discloses known problems to them, and values their comments and recommendations.
  - Underbillings by suppliers or overpayments by users or customers are quickly corrected.
  - The agency has a well-defined and understood process for dealing with employee claims and concerns in a timely and appropriate manner.
- 4. Appropriate disciplinary action is taken in response to departures from approved policies and procedures or violations of the code of conduct. Consider the following:**
- Management takes action when there are violations of policies, procedures, or the code(s) of conduct.
  - The types of disciplinary actions that can be taken are widely communicated throughout the agency so that others know that if they behave improperly, they will face similar consequences.
- 5. Management appropriately addresses intervention or overriding internal control. Consider the following:**
- Guidance exists concerning the circumstances and frequency with which intervention may be needed, and the management levels which may take such action.
  - Any intervention or overriding of internal control is fully documented as to reasons and specific actions taken.
  - Overriding of internal control by low-level management personnel is prohibited except in emergency situations, and upper-level management is immediately notified and the circumstances are documented.
- 6. Management removes temptation for unethical behavior. Consider the following:**
- Management has a sound basis for setting realistic and achievable goals and does not pressure employees to meet unrealistic ones.
  - Management provides fair, nonextreme incentives (as opposed to unfair and unnecessary temptations) to help ensure integrity and adherence to ethical values.
  - Compensation and promotion are based on achievements and performance.

## **Commitment to Competence**

### **1. Management has identified and defined the tasks required to accomplish particular jobs and fill the various positions. Consider the following:**

- Management has analyzed the tasks that need to be performed for particular jobs and given consideration to such things as the level of judgment required and the extent of supervision necessary.
- Formal job descriptions or other means of identifying and defining specific tasks required for job positions have been established and are up-to-date.

### **2. The agency has performed analyses of the knowledge, skills, and abilities needed to perform jobs appropriately. Consider the following:**

- The knowledge, skills, and abilities needed for various jobs have been identified and made known to employees.
- Evidence exists that the agency attempts to assure that employees selected for various positions have the requisite knowledge, skills, and abilities.

**3. The agency provides training and counseling in order to help employees maintain and improve their competence for their jobs. Consider the following:**

- There is an appropriate training program to meet the needs of all employees.
- The agency emphasizes the need for continuing training and has a control mechanism to help ensure that all employees actually received appropriate training.
- Supervisors have the necessary management skills and have been trained to provide effective job performance counseling.
- Performance appraisals are based on an assessment of critical job factors and clearly identify areas in which the employee is performing well and areas that need improvement.
- Employees are provided candid and constructive job performance counseling.

**4. Key senior-level employees have a demonstrated ability in general management and extensive practical experience in operating governmental or business entities.**

**Management's Philosophy and Operating Style**

**1. Management has an appropriate attitude toward risktaking, and proceeds with new ventures, missions, or operations only after carefully analyzing the risks involved and determining how they may be minimized or mitigated.**

**2. Management enthusiastically endorses the use of performance-based management.**

**3. There has not been excessive personnel turnover in key functions, such as operations and program management, accounting, or internal audit, that would indicate a problem with the agency's emphasis on internal control. Consider the following:**

- There has not been excessive turnover of supervisory personnel related to internal control problems, and there is a strategy for dealing with turnover related to constraints and limitations such as salary caps.
- Key personnel have not quit unexpectedly.
- Personnel turnover has not been so great as to impair internal control as a result of employing many people new to their jobs and unfamiliar with the control activities and responsibilities.
- There is no pattern to personnel turnover that would indicate a problem with the emphasis that management places on internal control.

**4. Management has a positive and supportive attitude toward the functions of accounting, information management systems, personnel operations, monitoring, and internal and external audits and evaluations. Consider the following:**

- The financial accounting and budgeting operations are considered essential to the well-being of the organization and viewed as methods for exercising control over the entity's various activities.
- Management regularly relies on accounting/financial and programmatic data from its systems for decision making purposes and performance evaluation.
- If the accounting operation is decentralized, unit accounting personnel also have reporting responsibility to the central financial officer(s).

- The financial management, accounting operations, and budget execution operations are under the direction of the Chief Financial Officer (CFO) and strong synchronization and coordination exists between budgetary and proprietary financial accounting activities.
- Management looks to the information management function for critical operating data and supports efforts to make improvements in the systems as technology advances.
- Personnel operations have a high priority and senior executives emphasize the importance of good human capital management.
- Management places a high degree of importance on the work of the Inspector General, external audits, and other evaluations and studies and is responsive to information developed through such products.

**5. Valuable assets and information are safeguarded from unauthorized access or use.**

**6. There is frequent interaction between senior management and operating/program management, especially when operating from geographically dispersed locations.**

**7. Management has an appropriate attitude toward financial, budgetary, and operational/programmatic reporting. Consider the following:**

- Management is informed and involved in critical financial reporting issues and supports a conservative approach toward the application of accounting principles and estimates.
- Management discloses all financial, budgetary, and programmatic information needed to fully understand the operations and financial condition of the agency.
- Management avoids focus on short-term reported results.
- Personnel do not submit inappropriate or inaccurate reports in order to meet targets.
- Facts are not exaggerated and budgetary estimates are not stretched to a point of unreasonableness.

## **Organizational Structure**

**1. The agency's organizational structure is appropriate for its size and the nature of its operations. Consider the following:**

- The organizational structure facilitates the flow of information throughout the agency.
- The organizational structure is appropriately centralized or decentralized, given the nature of its operations, and management has clearly articulated the considerations and factors taken into account in balancing the degree of centralization versus decentralization.

**2. Key areas of authority and responsibility are defined and communicated throughout the organization.**

- Executives in charge of major activities or functions are fully aware of their duties and responsibilities.
- An accurate and updated organizational chart showing key areas of responsibility is provided to all employees.
- Executives and key managers understand their internal control responsibilities and ensure that their staff also understand their own responsibilities.

**3. Appropriate and clear internal reporting relationships have been established. Consider the following:**

- Reporting relationships have been established and effectively provide managers information they need to carry out their responsibilities and perform their jobs.
  - Employees are aware of the established reporting relationships.
  - Mid-level managers can easily communicate with senior operating executives.
- 4. Management periodically evaluates the organizational structure and makes changes as necessary in response to changing conditions.**

**5. The agency has the appropriate number of employees, particularly in managerial positions. Consider the following:**

- Managers and supervisors have time to carry out their duties and responsibilities.
- Employees do not have to work excessive overtime or outside the ordinary workweek to complete assigned tasks.
- Managers and supervisors are not fulfilling the roles of more than one employee.

### **Assignment of Authority and Responsibility**

**1. The agency appropriately assigns authority and delegates responsibility to the proper personnel to deal with organizational goals and objectives. Consider the following:**

- Authority and responsibility are clearly assigned throughout the organization and this is clearly communicated to all employees.
- Responsibility for decision-making is clearly linked to the assignment of authority, and individuals are held accountable accordingly.
- Along with increased delegation of authority and responsibility, management has effective procedures to monitor results.

**2. Each employee knows (1) how his or her actions interrelate to others considering the way in which authority and responsibilities are assigned, and (2) is aware of the related duties concerning internal control. Consider the following:**

- Job descriptions clearly indicate the degree of authority and accountability delegated to each position and the responsibilities assigned.
- Job descriptions and performance evaluations contain specific references to internal control-related duties, responsibilities, and accountability.

**3. The delegation of authority is appropriate in relation to the assignment of responsibility. Consider the following:**

- Employees at the appropriate levels are empowered to correct problems or implement improvements.
- There is an appropriate balance between the delegation of authority at lower levels to get the job done, and the involvement of senior-level personnel.

### **Human Resource Policies and Practices**

**1. Policies and procedures are in place for hiring, orienting, training, evaluating, counseling, promoting, compensating, disciplining, and terminating employees. Consider the following:**

- Management communicates information to recruiters about the type of competencies needed for the work or participates in the hiring process.
- The agency has standards or criteria for hiring qualified people, with emphasis on education, experience, accomplishment, and ethical behavior.
- Position descriptions and qualifications are in accordance with OPM guidance and standardized throughout the agency for similar jobs.
- A training program has been established and includes orientation programs for new employees and ongoing training for all employees.
- Promotion, compensation, and rotation of employees are based on periodic performance appraisals.
- Performance appraisals are linked to the goals and objectives included in the agency's strategic plan.
- The importance of integrity and ethical values is reflected in performance appraisal criteria.
- Employees are provided with appropriate feedback and counseling on their job performance and suggestions for improvements.
- Disciplinary or remedial action is taken in response to violations of policies or ethical standards.
- Employment is terminated, following established policies, when performance is consistently below standards or there are significant and serious violations of policy.
- Management has established criteria for employee retention and considers the effect upon operations if large numbers of employees are expected to leave or retire in a given period.

**2. Background checks are conducted on candidates for employment. Consider the following:**

- Candidates who change jobs often are given particularly close attention.
- Hiring standards require investigations for criminal records for all potential employees.
- References and previous employers are contacted.
- Educational and professional certifications are confirmed.

**3. Employees are provided a proper amount of supervision. Consider the following:**

- Employees receive guidance, review, and on-the-job training from supervisors to help ensure proper work flow and processing of transactions and events, reduce misunderstandings, and discourage wrongful acts.
- Supervisory personnel ensure that staffs are aware of their duties and responsibilities and management's expectations.

## **Oversight Groups**

**1. Within the agency, there are mechanisms in place to monitor and review operations and programs. Consider the following:**

- An Inspector General, who is independent from management, audits and reviews agency activities.



- The agency has an audit committee or senior management council consisting of high-level line and staff executives that review the internal audit work and coordinate closely with the Inspector General and external auditors.
  - If there is an internal audit operation it reports to the agency head.
  - The internal audit function reviews that agency's activities and systems and provides information, analyses, appraisals, recommendations, and counsel to management.
- 2. The agency works closely with executive branch oversight organizations. Consider the following:**
- The agency has a good working relationship with OMB, and major officials, including the CFO, meet regularly with OMB personnel to discuss areas such as financial and budgetary reporting, internal control, and management's performance.
  - High-level agency personnel maintain good working relationships with other executive branch agencies that exercise multi-agency control responsibilities, such as the Department of the Treasury, the General Services Administration, and OPM.
- 3. The agency maintains a close relationship with Congress in general and oversight committees in particular. Consider the following:**
- The agency provides Congress and oversight committees with timely and accurate information to allow monitoring of agency activities, including review of the agency's (1) mission and goals, (2) performance reporting, and (3) financial position and operating results.
  - Agencies may or may not have an internal audit function separate and apart from the Inspector General.
  - High-level agency officials meet regularly with congressional and GAO staff to discuss major issues affecting operations, internal control, performance, and other major agency activities and programs.

## **RISK ASSESSMENT**

### **Establishment of Entity wide Objectives**

- 1. The agency has established entity wide objectives that provide sufficiently broad statements and guidance about what the agency is supposed to achieve, yet are specific enough to relate directly to the agency. Consider the following:**
- Management has established overall entitywide objectives in the form of mission, goals, and objectives, such as those defined in strategic and annual performance plans developed under the GPRA.
  - The entitywide objectives relate to and stem from program requirements established by legislation.
  - The entitywide objectives are specific enough to clearly apply to the agency instead of applying to all agencies.
- 2. Entity wide objectives are clearly communicated to all employees, and management obtains feedback signifying that the communication has been effective.**
- 3. There is a relationship and consistency between the agency's operational strategies and the entity wide objectives. Consider the following:**

- Strategic plans support the entitywide objectives.
- Strategic plans address resource allocations and priorities.
- Strategic plans and budgets are designed with an appropriate level of detail for various management levels.
- Assumptions made in strategic plans and budgets are consistent with the agency's historical experience and current circumstances.

**4. The agency has an integrated management strategy and risk assessment plan that considers the entity wide objectives and relevant sources of risk from internal management factors and external sources and establishes a control structure to address those risks.**

### **Establishment of Activity-Level Objectives**

**1. Activity-level (program or mission-level) objectives flow from and are linked with the agency's entity wide objectives and strategic plans. Consider the following:**

- All significant activities are adequately linked to the entity wide objectives and strategic plans.
- Activity-level objectives are reviewed periodically to assure that they have continued relevance.

**2. Activity-level objectives are complementary, reinforce each other, and are not contradictory.**

**3. The activity-level objectives are relevant to all significant agency processes. Consider the following:**

- Objectives have been established for the entire key operational activities and the support activities.
- Activity-level objectives are consistent with effective past practices and performance, and are consistent with any industry or business norms that may be applicable to the agency's operations.

**4. Activity-level objectives include measurement criteria.**

**5. Agency resources are adequate relative to the activity level objectives. Consider the following:**

- The resources needed to meet the objectives have been identified.
- If adequate resources are not available, management has plans to acquire them.

**6. Management has identified those activity-level objectives that are critical to the success of the overall entity wide objectives. Consider the following:**

- Management has identified the things that must occur or happen if the entitywide objectives are to be met.
- The critical activity-level objectives receive particular attention and review from management and their performance is monitored regularly.

**7. All levels of management are involved in establishing the activity-level objectives and are committed to their achievement.**

## **Risk Identification**

### **1. Management comprehensively identifies risk using various methodologies as appropriate. Consider the following:**

- Qualitative and quantitative methods are used to identify risk and determine relative risk rankings on a scheduled and periodic basis.
- How risk is to be identified, ranked, analyzed, and mitigated is communicated to appropriate staff.
- Risk identification and discussion occur in senior level management conferences.
- Risk identification takes place as a part of short-term and long-term forecasting and strategic planning.
- Risk identification occurs as a result of consideration of findings from audits, evaluations, and other assessments.
- Risks that are identified at the employee and mid-management level are brought to the attention of senior-level managers.

### **2. Adequate mechanisms exist to identify risks to the agency arising from external factors. Consider the following:**

- The agency considers the risks associated with technological advancements and developments.
- Consideration is given to risks arising from the changing needs or expectations of Congress, agency officials, and the public.
- Risks posed by new legislation or regulations are identified.
- Risks to the agency as a result of possible natural catastrophes or criminal or terrorist actions are taken into account.
- Identification of risks resulting from business, political, and economic changes are determined.
- Consideration is given to the risks associated with major suppliers and contractors.
- The agency carefully considers any risks resulting from its interactions with various other federal entities and parties outside the government.

### **3. Adequate mechanisms exist to identify risks to the agency arising from internal factors. Consider the following:**

- Risks resulting from downsizing of agency operations and personnel are considered.
- The agency identifies risks associated with business process reengineering or redesign of operating processes.
- Consideration is given to risks posed by disruption of information systems processing and the extent to which backup systems are available and can be implemented.
- The agency identifies any potential risks due to highly decentralized program operations.
- Consideration is given to possible risks resulting from the lack of qualifications of personnel hired or the extent to which they have been trained or not trained.
- Risks resulting from heavy reliance on contractors or other related parties to perform critical agency operations are identified.
- The agency identifies any risks that might be associated with major changes in managerial responsibilities.

- Risks resulting from unusual employee access to vulnerable assets are considered.
  - Risk identification activities consider certain human capital-related risks, such as the inability to provide succession planning and retain key personnel who can affect the ability of the agency or program activity to function effectively, and the inadequacy of compensation and benefit programs to keep the agency competitive with the private sector for labor.
  - Risks related to the availability of future funding for new programs or the continuations of current programs are assessed.
- 4. In identifying risk, management assesses other factors that may contribute to or increase the risk to which the agency is exposed. Consider the following:**
- Management considers any risks related to past failures to meet agency missions, goals, or objectives or failures to meet budget limitations.
  - Consideration is given to risks indicated by a history of improper program expenditures, violations of funds control, or other statutory noncompliance.
  - The agency identifies any risks inherent to the nature of its mission or to the significance and complexity of any specific programs or activities it undertakes.
- 5. Management identifies risks both entitywide and for each significant activity-level of the agency.**

## **Risk Analysis**

- 1. After the risks to the agency have been identified, management undertakes a thorough and complete analysis of their possible effect. Consider the following:**
- Management has established a formal process to analyze risks, and that process may include informal analysis based on day-to-day management activities.
  - Criteria have been established for determining low, medium, and high risks.
  - Appropriate levels of management and employees are involved in the risk analysis.
  - The risks identified and analyzed are relevant to the corresponding activity objective.
  - Risk analysis includes estimating the risk's significance.
  - Risk analysis includes estimating the likelihood and frequency of occurrence of each risk and determining whether it falls into the low, medium, or high-risk category.
  - A determination is made on how best to manage or mitigate the risk and what specific actions should be taken.
- 2. Management has developed an approach for risk management and control based on how much risk can be prudently accepted. Consider the following:**
- The approach can vary from one agency to another depending upon variances in risks and how much risk can be tolerated, but seems appropriate to the agency.
  - The approach is designed to keep risks within levels judged to be appropriate and management takes responsibility for setting the tolerable risk level.
  - Specific control activities are decided upon to manage or mitigate specific risks entity wide and at each activity level, and their implementation is monitored.

## **Managing Risk during Change**

**1. The agency has mechanisms in place to anticipate, identify, and react to risks presented by changes in governmental, economic, industry, regulatory, operating, or other conditions that can affect the achievement of entitywide or activity-level goals and objectives. Consider the following:**

- All activities within the agency that might be significantly affected by changes are considered in the process.
- Routine changes are addressed through the established risk identification and analysis processes.
- Risks resulting from conditions that are significantly changing are addressed at sufficiently high levels within the agency so that their full impact on the organization is considered and appropriate actions are taken.

**2. The agency gives special attention to risks presented by changes that can have a more dramatic and pervasive effect on the entity and may demand the attention of senior officials. Consider the following:**

- The agency is especially attentive to risks caused by the hiring of new personnel to occupy key positions or by high personnel turnover in any particular area.
- Mechanisms exist to assess the risks posed by the introduction of new or changed information systems and risks involved in training employees to use the new systems and to accept the changes.
- Management gives special consideration to the risks presented by rapid growth and expansion or rapid downsizing and the effects on systems capabilities and revised strategic plans, goals, and objectives.
- Consideration is given to the risks involved when introducing major new technological developments and applications and incorporating them into the operating processes.
- The risks are extensively analyzed whenever the agency begins the production or provision of new outputs or services.
- Risks resulting from the establishment of operations in a new geographical area are assessed.

## **CONTROL ACTIVITIES**

### **General Application**

**1. Appropriate policies, procedures, techniques, and mechanisms exist with respect to each of the agency's activities. Consider the following:**

- All relevant objectives and associated risks for each significant activity have been identified in conjunction with conducting the risk assessment and analysis function.
- Management has identified the actions and control activities needed to address the risks and directed their implementation.

**2. The control activities identified as necessary are in place and being applied. Consider the following:**

- Control activities described in policy and procedures manuals are actually applied and applied properly.
- Supervisors and employees understand the purpose of internal control activities.
- Supervisory personnel review the functioning of established control activities and remain alert for instances in which excessive control activities should be streamlined.
- Timely action is taken on exceptions, implementation problems, or information that requires follow-up.

**3. Control activities are regularly evaluated to ensure that they are still appropriate and working as intended.**

**Common Categories of Control Activities**

**1. Top-Level Reviews . Management tracks major agency achievements in relation to its plans. Consider the following:**

- Top-level management regularly reviews actual performance against budgets, forecasts, and prior period results.
- Top management is involved in developing 5-year and annual performance plans and targets in accordance with GPRA and measuring and reporting results against those plans and targets.
- Major agency initiatives are tracked for target achievement and follow-up actions are taken.

**2. Management Reviews at the Functional or Activity Level . Agency managers review actual performance against targets. Consider the following:**

- Managers at all activity levels review performance reports, analyze trends, and measure results against targets.
- Both financial and program managers' review and compare financial, budgetary, and operational performance to planned or expected results.
- Appropriate control activities are employed, such as reconciliations of summary information to supporting detail and checking the accuracy of summarizations of operations.

**3. Management of Human Capital . The agency effectively manages the organization's workforce to achieve results. Consider the following:**

- A clear and coherent shared vision of agency mission, goals, values, and strategies is explicitly identified in the strategic plan, annual performance plan, and other guiding documents, and that view has been clearly and consistently communicated to all employees.
- The agency has a coherent overall human capital strategy, as evidenced in its strategic plan, performance plan, or separate human capital planning document; and that strategy encompasses human capital policies, programs, and practices to guide the agency.
- The agency has a specific and explicit workforce planning strategy, linked to the overall strategic plan, and that allows for identification of current and future human capital needs.

- The agency has defined the type of leaders it wants through written descriptions of roles, responsibilities, attributes, and competencies and has established broad performance expectations for them.
- Senior leaders and managers attempt to build teamwork, reinforce the shared vision of the agency, and encourage feedback from employees, as evidenced by actions taken to communicate this to all employees and the existence of opportunities for management to obtain feedback.
- The agency's performance management system is given a high priority by top-level officials, and it is designed to guide the workforce to achieve the agency's shared vision/mission.
- Procedures are in place to ensure that personnel with appropriate competencies are recruited and retained for the work of the agency, including a formal recruiting and hiring plan with explicit links to skill needs the agency has identified.
- Employees are provided orientation, training, and tools to perform their duties and responsibilities, improve performance, enhance their capabilities, and meet the demands of changing organizational needs.
- The compensation system is adequate to acquire, motivate, and retain personnel, and incentives and rewards are provided to encourage personnel to perform at maximum capability.
- The agency provides workplace flexibilities, services, and facilities (e.g., career counseling, flextime, casual-dress days, and childcare) to help it compete for talent and enhance employee satisfaction and commitment.
- Qualified and continuous supervision is provided to ensure that internal control objectives are being met.
- Meaningful, honest, constructive performance evaluation and feedback are provided to help employees understand the connection between their performance and the achievement of the agency's goals.
- Management conducts succession planning to ensure continuity of needed skills and abilities.

**4. Information Processing. The agency employs a variety of control activities suited to information processing systems to ensure accuracy and completeness. Consider the following:**

- Edit checks are used in controlling data entry.
- Accounting for transactions is performed in numerical sequences.
- File totals are compared with control accounts.
- Exceptions or violations indicated by other control activities are examined and acted upon.
- Access to data, files, and programs is appropriately controlled.

**5. Physical Control Over Vulnerable Assets . The agency employs physical control to secure and safeguard vulnerable assets. Consider the following:**

- Physical safeguarding policies and procedures have been developed, implemented, and communicated to all employees.
- The agency has developed a disaster recovery plan, which is regularly updated and communicated to employees.

- The agency has developed a plan for the identification of and protection of any critical infrastructure assets.
- Assets that are particularly vulnerable to loss, theft, damage, or unauthorized use, such as cash, securities, supplies, inventories, and equipment, are physically secured and access to them controlled.
- Assets such as cash, securities, supplies, inventories, and equipment are periodically counted and compared to control records and exceptions examined.
- Cash and negotiable securities are maintained under lock and key and access to them strictly controlled.
- Forms such as blank checks and purchase orders are sequentially pre-numbered and physically secured and access to them strictly controlled.
- Mechanical check signers and signature plates are physically protected and access to them strictly controlled.
- Equipment vulnerable to theft is securely fastened or protected in some other manner.
- Identification plates and numbers are affixed to office furniture and fixtures, equipment, and other portable assets. Critical infrastructure assets are those assets of physical and cyber-based systems that are essential to the minimum operations of the economy and government. Inventories, supplies, and finished items/goods are stored in physically secured areas and protected from damage.
- Facilities are protected from fire by fire alarms and sprinkler systems.
- Access to premises and facilities is controlled by fences, guards, and/or other physical controls.
- Access to facilities is restricted and controlled during nonworking hours.

**6. Performance Measures and Indicators . The agency has established and monitors performance measures and indicators. Consider the following:**

- Performance measures and indicators have been established throughout the organization at the entitywide, activity, and individual level.
- The agency periodically reviews and validates the propriety and integrity of both organizational and individual performance measures and indicators.
- Performance measurement assessment factors are evaluated to ensure they are linked to mission, goals, and objectives, and are balanced and set appropriate incentives for achieving goals while complying with law, regulations, and ethical standards.
- Actual performance data are continually compared against expected/planned goals and differences are analyzed.
- Comparisons are made relating different sets of data to one another so that analyses of the relationships can be made and corrective actions can be taken if necessary.
- Investigation of unexpected results or unusual trends leads to identification of circumstances in which the achievement of goals and objectives may be threatened and corrective action is taken.
- Analysis and review of performance measures and indicators are used for both operational and financial reporting control purposes.



**7. Segregation of Duties. Key duties and responsibilities are divided or segregated among different people to reduce the risk of error, waste, or fraud. Consider the following:**

- No one individual is allowed to control all key aspects of a transaction or event.
- Responsibilities and duties involving transactions and events are separated among different employees with respect to authorization, approval, processing and recording, making payments or receiving funds, review and auditing, and the custodial functions and handling of related assets.
- Duties are assigned systematically to a number of individuals to ensure that effective checks and balances exist.
- Where feasible, no one individual is allowed to work alone with cash, negotiable securities, or other highly venerable assets.
- The responsibility for opening mail is assigned to individuals who have no responsibilities for or access to files or documents pertaining to accounts receivable or cash accounts.
- Bank accounts are reconciled by employees who have no responsibilities for cash receipts, disbursements, or custody.
- Management is aware that collusion can reduce or destroy the control effectiveness of segregation of duties and, therefore, is especially alert for it and attempts to reduce the opportunities for it to occur.

**8. Execution of Transactions and Events . Transactions and other significant events are authorized and performed by the appropriate personnel. Consider the following:**

- Controls ensure that only valid transactions and other events are initiated or entered into, in accordance with management's decisions and directives.
- Controls are established to ensure that all transactions and other significant events that are entered into are authorized and executed only by employees acting within the scope of their authority.
- Authorizations are clearly communicated to managers and employees and include the specific conditions and terms under which authorizations are to be made.
- The terms of authorizations are in accordance with directives and within limitations established by law, regulation, and management.

**9. Recording of Transactions and Events . Transactions and other significant events are properly classified and promptly recorded. Consider the following:**

- Transactions and events are appropriately classified and promptly recorded so that they maintain their relevance, value, and usefulness to management in controlling operations and making decisions.
- Proper classification and recording take place throughout the entire life cycle of each transaction or event, including authorization, initiation, processing, and final classification in summary records.
- Proper classification of transactions and events includes appropriate organization and format of information on original documents (hardcopy paper or electronic) and summary records from which reports and statements are prepared.
- Excessive adjustments to numbers or account classifications are not necessary prior to finalization of financial reports.

**10. Access Restrictions to and Accountability for Resources and Records . Access to resources and records is limited and accountability for their custody is assigned. Consider the following:**

- The risk of unauthorized use or loss is controlled by restricting access to resources and records only to authorized personnel.
- Accountability for resources and records custody and use is assigned to specific individuals.
- Access restrictions and accountability assignments for custody are periodically reviewed and maintained.
- Periodic comparison of resources with the recorded accountability is made to determine if the two agree, and differences are examined.
- How frequently actual resources are compared to records and the degree of access restrictions are functions of the vulnerability of the resource to the risk of errors, fraud, waste, misuse, theft, or unauthorized alteration.
- Management considers such factors as asset value, portability, and exchangeability when determining the appropriate degree of access restrictions.
- As a part of assigning and maintaining accountability for resources and records, management informs and communicates those responsibilities to specific individuals within the agency and assures that those people are aware of their duties for appropriate custody and use of those resources.

**11. Documentation. Internal Control and all transactions and other significant events are clearly documented. Consider the following:**

- Written documentation exists covering the agency's internal control structure and for all significant transactions and events.
- The documentation is readily available for examination.
- The documentation for internal control includes identification of the agency's activity-level functions and related objectives and control activities and appears in management directives, administrative policies, accounting manuals, and other such manuals.
- Documentation for internal control includes documentation describing and covering automated information systems, data collection and handling, and the specifics of general and application control related to such systems.
- Documentation of transactions and other significant events is complete and accurate and facilitates tracing the transaction or event and related information from authorization and initiation, through its processing, to after it is completed.
- Documentation, whether in paper or electronic form, is useful to managers in controlling their operations and to any others involved in evaluating or analyzing operations.
- All documentation and records are properly managed, maintained, and periodically updated.

## **Control Activities Specific for Information Systems. General Control Entity wide Security Management Program**

**1. The agency periodically performs a comprehensive, high-level assessment of risks to its information systems. Consider the following:**

- Risk assessments are performed and documented regularly and whenever systems, facilities, or other conditions change.
  - Risk assessments consider data sensitivity and integrity.
  - Final risk determinations and managerial approvals are documented and kept on file.
- 2. The agency has developed a plan that clearly describes the entitywide security program and policies and procedures that support it.**
- 3. Senior management has established a structure to implement and manage the security program throughout the agency and security responsibilities are clearly defined.**

**4. The agency has implemented effective security-related personnel policies.**

**5. The agency monitors the security program's effectiveness and makes changes as needed. Consider the following:**

- Management periodically assesses the appropriateness of security policies and compliance with them.
- Corrective actions are promptly and effectively implemented and tested, and they are continually monitored.

## **Access Control**

**1. The agency classifies information resources according to their criticality and sensitivity. Consider the following:**

- Resource classifications and related criteria have been established and communicated to resource owners.
- Resource owners have classified their information resources based on the approved criteria and with regard to risk determinations and assessments and have documented those classifications.

**2. Resource owners have identified authorized users and their access to the information has been formally authorized.**

**3. The agency has established physical and logical controls to prevent or detect unauthorized access.**

**4. The agency monitors information systems access, investigates apparent violations, and takes appropriate remedial and disciplinary action.**

## **Application Software Development and Change Control**

**1. Information system processing features and program modifications are properly authorized.**

**2. All new or revised software is thoroughly tested and approved.**

**3. The agency has established procedures to ensure control of its software libraries, including labeling, access restrictions, and use of inventories and separate libraries.**

### **System Software Control**

- 1. The agency limits access to system software based on job responsibilities, and access authorization is documented.**
- 2. Access to and use of system software are controlled and monitored.**
- 3. The agency controls changes made to the system software.**

### **Segregation of Duties**

- 1. Incompatible duties have been identified and policies implemented to segregate those duties.**
- 2. Access controls have been established to enforce segregation of duties.**
- 3. The agency exercises control over personnel activities through the use of formal operating procedures, supervision, and review.**

### **Service Continuity**

- 1. The criticality and sensitivity of computerized operations have been assessed and prioritized, and supporting resources have been identified.**
- 2. The agency has taken steps to prevent and minimize potential damage and interruption through the use of data and program backup procedures including offsite storage of backup data as well as environmental controls, staff training, and hardware maintenance and management.**
- 3. Management has developed and documented a comprehensive contingency plan.**
- 4. The agency periodically tests the contingency plan and adjusts it as appropriate.**

### **Control Activities Specific for Information Systems. Application Control Authorization Control**

- 1. Source documents are controlled and require authorization. Consider the following:**
  - Access to blank source documents is restricted.
  - Source documents are pre-numbered sequentially.
  - Key source documents require authorizing signatures.
  - For batch application systems, batch control sheets are used providing information such as date, control number, number of documents, and control totals for key fields.
  - Supervisory or independent review of data occurs before it is entered into the application system.
- 2. Data entry terminals have restricted access.**
- 3. Master files and exception reporting are used to ensure that all data processed are authorized.**

### **Completeness Control Comments/Descriptions**

- 1. All authorized transactions are entered into and processed by the computer.**
- 2. Reconciliations are performed to verify data completeness.**

### **Accuracy Control**

- 1. The agency's data entry design features contribute to data accuracy.**
- 2. Data validation and editing are performed to identify erroneous data.**
- 3. Erroneous data are captured, reported, investigated, and promptly corrected.**
- 4. Output reports are reviewed to help maintain data accuracy and validity.**

### **Control Over Integrity of Processing and Data Files**

- 1. Procedures ensure that the current versions of production programs and data files are used during processing.**
- 2. Programs include routines to verify that the proper version of the computer file is used during processing.**
- 3. Programs include routines for checking internal file header labels before processing.**
- 4. The application protects against concurrent file updates.**

## **INFORMATION AND COMMUNICATIONS**

### **Information Comments/Descriptions**

**1. Information from internal and external sources is obtained and provided to management as a part of the agency's reporting on operational performance relative to established objectives. Consider the following:**

- Internally generated information critical to achieving the agency's objectives, including information relative to critical success factors, is identified and regularly reported to management.
- The agency obtains and reports to managers any relevant external information that may affect the achievement of its missions, goals, and objectives particularly that related to legislative or regulatory developments and political or economic changes.
- Internal and external information needed by managers at all levels is reported to them.

**2. Pertinent information is identified, captured, and distributed to the right people in sufficient detail, in the right form, and at the appropriate time to enable them to carry out their duties and responsibilities efficiently and effectively. Consider the following:**

- Managers receive analytical information that helps them identify specific actions that need to be taken.
- Information is provided at the right level of detail for different levels of management.
- Information is summarized and presented appropriately and provides pertinent information while permitting a closer inspection of details as needed.
- Information is available on a timely basis to allow effective monitoring of events, activities, and transactions and to allow prompt reaction.
- Program managers receive both operational and financial information to help them determine whether they are meeting the strategic and annual performance plans and meeting the agency's goals for accountability of resources.

- Operational information is provided to managers so that they may determine whether their programs comply with applicable laws and regulations.
- The appropriate financial and budgetary information is provided for both internal and external financial reporting.

## **Communications**

### **1. Management ensures that effective internal communications occur. Consider the following:**

- Top management provides a clear message throughout the agency that internal control responsibilities are important and must be taken seriously.
- Employees' specific duties are clearly communicated to them and they understand the relevant aspects of internal control, how their role fits into it, and how their work relates to the work of others.
- Employees are informed that when the unexpected occurs in performing their duties, attention must be given not only to the event, but also to the underlying cause, so that potential internal control weaknesses can be identified and corrected before they can do further harm to the agency.
- Acceptable behavior versus unacceptable behavior and the consequences of improper conduct are clearly communicated to all employees.
- Personnel have a means of communicating information upstream within the agency through someone other than a direct supervisor, and there is a genuine willingness to listen on the part of management.
- Mechanisms exist to allow the easy flow of information down, across, and up the organization, and easy communications exist between functional activities, such as between procurement activities and production activities.
- Employees indicate that informal or separate lines of communications exist, which serve as a fail-safe control for normal communications avenues.
- Personnel understand that there will be no reprisals for reporting adverse information, improper conduct, or circumvention of internal control activities.
- Mechanisms are in place for employees to recommend improvements in operations, and management acknowledges good employee suggestions with cash awards or other meaningful recognition.
- Management communicates frequently with internal oversight groups, such as senior management councils, and keeps them informed of performance, risks, major initiatives, and any other significant events.

### **2. Management ensures that effective external communications occur with groups that can have a serious impact on programs, projects, operations, and other activities, including budgeting and financing. Consider the following:**

- Open and effective communications channels have been established with customers, suppliers, contractors, consultants, and other groups that can provide significant input on quality and design of agency products and services.
- All outside parties dealing with the agency are clearly informed of the agency's ethical standards and also understand that improper actions, such as improper billings, kickbacks, or other improper payments, will not be tolerated.

- Communications from external parties, such as other federal agencies, state and local governments, and other related third parties, is encouraged since it can be a source of information on how well internal control is functioning.
- The agency has methods to ensure compliance with the Federal Advisory Committee Act of 1972 since such committees may include individuals external to the agency with whom communications could occur.
- Complaints or inquiries, especially those concerning services, such as shipments, receipts, and billings, are welcomed since they can point out control problems.
- Management makes certain that the advice and recommendations of Inspectors General and other auditors and evaluators are fully considered and that actions are implemented to correct any problems or weaknesses they identify.
- Communications with Congress, OMB, Treasury, other federal agencies, state and local governments, the media, the public, and others provide information relevant to the requesters needs so that they can better understand the agency's mission, goals, and objectives, better understand the risks facing the agency, and thus better understand the agency.

### **Forms and Means of Communications Comments/Descriptions**

#### **1. The agency employs many and various forms and means of communicating important information with employees and others. Consider the following:**

- Management uses effective communications methods, which may include policy and procedures manuals, management directives, memoranda, bulletin board notices, internet and intranet web pages, videotaped messages, e-mail, and speeches.
- Two of the most powerful forms of communications used by management are the positive actions it takes in dealing with personnel throughout the organization and its demonstrated support of internal control.

#### **2. The agency manages, develops, and revises its information systems in an effort to continually improve the usefulness and reliability of its communication of information. Consider the following:**

- Information systems management is based on a strategic plan for information systems that is linked to the agency's overall strategic plan.
- A mechanism exists for identifying emerging information needs.
- As part of the agency's information management, improvements and advances in technology are monitored, analyzed, evaluated, and introduced to help the agency respond more rapidly and efficiently to those it serves.
- Management continually monitors the quality of the information captured, maintained, and communicated as measured by such factors as appropriateness of content, timeliness, accuracy, and accessibility.
- Management's support for the development of information technology is demonstrated by its commitment of appropriate human and financial resources to the effort.

## **MONITORING**

### **Ongoing Monitoring**

**1. Management has a strategy to ensure that ongoing monitoring is effective and will trigger separate evaluations where problems are identified or systems are critical and testing is periodically desirable. Consider the following:**

- Management's strategy provides for routine feedback and monitoring of performance and control objectives.
- The monitoring strategy includes methods to emphasize to program and operational managers that they have responsibility for internal control and that they should monitor the effectiveness of control activities as a part of their regular duties.
- The monitoring strategy includes methods to emphasize to program managers their responsibility for internal control and their duties to regularly monitor the effectiveness of control activities.
- The monitoring strategy includes identification of critical operational and mission support systems that need special review and evaluation.
- The strategy includes a plan for periodic evaluation of control activities for critical operational and mission support systems.

**2. In the process of carrying out their regular activities, agency personnel obtain information about whether internal control is functioning properly. Consider the following:**

- Operating reports are integrated or reconciled with financial and budgetary reporting system data and used to manage operations on an ongoing basis, and management is aware of inaccuracies or exceptions that could indicate internal control problems.
- Operating management compares production, sales, or other operating information obtained in the course of its daily activities to system-generated information and follows up on any inaccuracies or other problems that might be found.
- Operating personnel are required to sign-off on the accuracy of their unit's financial statements and are held accountable if errors are discovered.

**3. Communications from external parties should corroborate internally generated data or indicate problems with internal control. Consider the following:**

- Management recognizes that customers paying for invoices help to corroborate billing data, while customer complaints indicate that deficiencies may exist; and these deficiencies are then investigated to determine the underlying causes.
- Communications from vendors and monthly statements of accounts payable are used as control monitoring techniques.
- Supplier complaints about any unfair practices by agency purchasing agents are investigated.
- Congress and oversight groups communicate information to the agency about compliance or other matters that reflect on the functioning of internal control, and management follows up on any problems indicated.
- Control activities that should have prevented or detected any problems that arose, but did not function properly, are reassessed.



**4. Appropriate organizational structure and supervision help provide oversight of internal control functions. Consider the following:**

- Automated edits and checks as well as clerical activities are used to help control accuracy and completeness of transaction processing.
- Separation of duties and responsibilities is used to help deter fraud.
- The Inspector General is independent and has authority to report directly to the agency head and does not conduct agency operations for management.

**5. Data recorded by information and financial systems are periodically compared with physical assets and discrepancies are examined. Consider the following:**

- Inventory levels of materials, supplies, and other assets are checked regularly; differences between recorded and actual amounts are corrected; and the reasons for the discrepancies resolved.
- The frequency of the comparison is a function of the vulnerability of the asset.
- Custodial accountability for assets and resources is assigned to responsible individuals.

**6. The Inspector General and other auditors and evaluators regularly provide recommendations for improvements in internal control with management taking appropriate follow-up action.**

**7. Meetings with employees are used to provide management with feedback on whether internal control is effective. Consider the following:**

- Relevant issues, information, and feedback concerning internal control raised at training seminars, planning sessions, and other meetings are captured and used by management to address problems or strengthen the internal control structure.
- Employee suggestions on internal control are considered and acted upon as appropriate.
- Management encourages employees to identify internal control weaknesses and report them to the next supervisory level.

**8. Employees are regularly asked to state explicitly whether they comply with the agency's code of conduct or similar agency pronouncements of expected employee behavior. Consider the following:**

- Personnel periodically acknowledge compliance with the code of conduct.
- Signatures are required to evidence performance of critical internal control functions, such as reconciliations.

## **Separate Evaluations**

**1. The scope and frequency of separate evaluations of internal control are appropriate for the agency. Consider the following:**

- Consideration is given to the risk assessment results and the effectiveness of ongoing monitoring when determining the scope and frequency of separate evaluations.
- Separate evaluations are often prompted by events such as major changes in management plans or strategies, major expansion or downsizing of the agency, or significant changes in operations or processing of financial or budgetary information.

- Appropriate portions or sections of internal control are evaluated regularly.
  - Separate evaluations are conducted by personnel with the required skills that may include the agency's Inspector General or an external auditor.
- 2. The methodology for evaluating the agency's internal control is logical and appropriate. Consider the following:**
- The methodology used may include self-assessments using checklists, questionnaires, or other such tools, and it may include the use of this Management and Evaluation Tool or some similar device.
  - The separate evaluations may include a review of the control design and direct testing of the internal control activities.
  - In agencies where large amounts of data are processed by the information and/or financial systems, separate evaluation methodology employs computer assisted audit techniques to identify indicators of inefficiencies, waste, or abuse.
  - The evaluation team develops a plan for the evaluation process to ensure a coordinated effort.
  - If the evaluation process is conducted by agency employees, it is managed by an executive with the requisite authority, capability, and experience.
  - The evaluation team gains a sufficient understanding of the agency's missions, goals, and objectives and its operations and activities.
  - The evaluation team gains an understanding of how the agency's internal control is supposed to work and how it actually does work.
  - The evaluation team analyzes the results of the evaluation against established criteria.
  - The evaluation process is properly documented.
- 3. If the separate evaluations are conducted by the agency's Inspector General, that office has sufficient resources, ability, and independence. Consider the following:**
- The Inspector General has sufficient levels of competent and experienced staff.
  - The Inspector General is organizationally independent and reports to the highest levels within the agency.
  - The responsibilities, scope of work, and audit plans of the Inspector General are appropriate to the agency's needs.
- 4. Deficiencies found during separate evaluations are promptly resolved. Consider the following:**
- Deficiencies are promptly communicated to the individual responsible for the function and also to at least one level of management above that individual.
  - Serious deficiencies and internal control problems are promptly reported to top management. This particular point and the related subsidiary points are not expected to be assessed by agency management or the agency Inspector General. However, their consideration may be useful in outside reviews or peer reviews.

## **Audit Resolution**

### **1. The agency has a mechanism to ensure the prompt resolution of findings from audits and other reviews. Consider the following:**

- Managers promptly review and evaluate findings resulting from audits, FMFIA and FFMIA assessments, and other reviews, including those showing deficiencies and those identifying opportunities for improvements.
- Management determines the proper actions to take in response to findings and recommendations.
- Corrective action is taken or improvements made within established time frames to resolve the matters brought to management's attention.
- In cases where there is disagreement with the findings or recommendations, management demonstrates that those findings or recommendations are either invalid or do not warrant action.
- Management considers consultations with auditors (such as GAO, the Inspector General, and other external auditors), and reviewers when they are believed to be helpful in the audit resolution process.

### **2. Agency management is responsive to the findings and recommendations of audits and other reviews aimed at strengthening internal control. Consider the following:**

- Executives with the proper authority evaluate the findings and recommendations and decide upon the appropriate actions to take to correct or improve control.
- Desired internal control actions are followed up on to verify implementation. Audit Resolution includes the resolution of findings and recommendations not just from formal audits, but also resulting from informal reviews, internal separate evaluations, management studies, and assessments made pursuant to the requirements of the Federal Managers' Financial Integrity Act (FMFIA) of 1982 and the Federal Financial Management Improvement Act (FFMIA) of 1996.

### **3. The agency takes appropriate follow-up actions with regard to findings and recommendations of audits and other reviews. Consider the following:**

- Problems with particular transactions or events are corrected promptly.
- The underlying causes giving rise to the findings or recommendations are investigated by management.
- Actions are decided upon to correct the situation or take advantage of the opportunity for improvements.
- Management and auditors follow up on audit and review findings, recommendations, and the actions decided upon to ensure that those actions are taken.
- Top management is kept informed through periodic reports on the status of audit and review resolution so that it can ensure the quality and timeliness of individual resolution decisions.

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